

REAL ESTATE SYNDICATION: PROPERTY, PROMOTION, AND THE NEED FOR PROTECTION

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READERS of the June 29, 1958, edition of the *New York Times* may have puzzled over a sixteen page advertising supplement urging them to buy units in a syndicate that would soon acquire the leasehold on one of Manhattan's prominent office buildings.¹ For many, this was their first glimpse of syndication—a technique that has become the vogue in real estate investment.² Syn-

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1. N.Y. Times, June 29, 1958, § 10. The promoters of Motors Building Realty Company sought to raise \$5,780,000 to acquire the leasehold of the General Motors Building.

2. Towards the end of World War II, several forces ended the doldrums which had characterized real estate investment throughout the 1930's and early 1940's. Individual savings accumulated during the war sought investment outlets. U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 436, 457 (1956). Lending institutions were ready to disgorge, often at bargain basement values, their depression-acquired foreclosed realty holdings. Municipally-owned land, the product of depression tax foreclosures, became attractively available to developers.

The governmental stimulus of insured or guaranteed mortgages, National Housing Act, 48 Stat. 1246 (1934), as amended, 12 U.S.C. § 1701 (1958); Servicemen's Readjustment Act of 1944, reenacted in amended form, 72 Stat. 1203, 38 U.S.C. § 1801 (1958), secondary market supports (Federal National Mortgage Association), 48 Stat. 1254 (1934), as amended, 12 U.S.C. §§ 1717-23 (1958), low interest rates, see, e.g., Chandler, *Federal Reserve Policy and the Federal Debt*, 39 AM. ECON. REV. 405 (1949), and easy-credit lending policies, see, e.g., P-H FED. AIDS TO FINANCING ¶ 18028 (no-down-payment mortgages were available to ex-G.I. homebuyers), helped finance a construction upsurge, see U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, *op. cit. supra* at 757.

Higher rentals, see *id.* at 324, generally improving business conditions, and inflation-increased real estate values, see *id.* at 315, partially restored public confidence and whetted investment appetite.

The real estate syndicate emerged in the early 1950's to help transform interest into action. Real estate syndication had its roots in the Metropolitan New York area. Currently the syndicators are extending their operations beyond New York as measured by the situs of acquired properties and the residence of promoters and investors. See Sherman, *Syndicating in the Baltimore Area*, in NATIONAL INSTITUTE OF REAL ESTATE BROKERS, REAL ESTATE SYNDICATES 42 (1957); Morris, *Florida Syndicates*, *id.* at 48; Wilbur, *How They Do It in Chicago*, *id.* at 52. See also Letter From Justin Hinders, Exec. Vice-Pres., Wash-

dication—the pooling of the resources of a group of individual investors to ac-

ington (D.C.) Real Estate Board, Inc., to Curtis J. Berger, Nov. 19, 1959, on file in Yale Law Library.

Syndicate ventures own (1) office buildings, *e.g.*, Graybar Building Associates, Prospectus, March 10, 1958; (2) apartment houses, see Stern, *Apartments Lure Many Syndicates*, N.Y. Times, May 19, 1957, § 8, p. 1, col. 7, at 6, cols. 1-3 (suggests that apartments may have unique advantages for syndicate investment); *Investors Seek Role in Housing*, N.Y. Times, July 26, 1959, § 8, p. 1, col. 2; *e.g.*, Texmar Realty Co., Certificate of Limited Partnership, filed N.Y. County Clerk's Office, Aug. 27, 1959 (apartments in Silver Spring, Md., and Dallas, Tex.); (3) hotels, see, *e.g.*, Drake Associates, Certificate of Limited Partnership, filed N.Y. County Clerk's Office, Aug. 19, 1959 (Hotel Drake, N.Y.C.); (4) motels, see, *e.g.*, Phoenix Motel Co., Certificate of Limited Partnership, filed N.Y. County Clerk's Office, April 22, 1959 (The Caravan Motel, Phoenix, Ariz.); (5) theatres, see, *e.g.*, National Munsey Co., Prospectus, Nov. 20, 1959 (Munsey Bldg. & National Theatre, Washington, D.C.); (6) bowling alleys, see Combined Bowling Co., Certificate of Limited Partnership, filed N.Y. County Clerk's Office, Sept. 10, 1959; (7) shopping centers, see Glen Oaks Shopping Center Realty Co., Certificate of Limited Partnership, filed N.Y. County Clerk's Office, May 27, 1959.

In addition, syndicates are being formed for the development of real estate improvements. See Greenblatt, *The Why and How of Real Estate Syndications: Syndication Illustrated*, Prac. Law., March 1959, p. 65, at 68; Falcro Associates, Offering Circular, 1959 (syndicate to construct and own 40 lane bowling establishment); Realty, Dec. 22, 1959, p. 31, col. 3 (parking garage); N.Y. Times, Nov. 22, 1958, p. 35, col. 6 (urban renewal project). The tightness of the institutional money market has been one factor leading to greater syndicate participation in construction. See *N.Y. Hearings on Real Estate Syndication Before Hon. George Frankenthaler*, Nov. 18, 1957, p. 2a, on file in New York City office of attorney general of New York State.

The author examined all notices of copartnership published in the *New York Law Journal* for limited partnerships that had filed certificates in the New York County (Manhattan) Clerk's Office during 1958 and 1959. Where it appeared that the partnership was acquiring an interest in real property, and not less than ten limited partners would invest in the venture, the formation of a real estate syndicate was inferred. Admittedly, the choice of ten or more investors is arbitrary. I resolved any uncertainties, as to the partnership purpose or the number of investors, against a real estate syndicate's existence.

Since the limited partnership is the most widely used, but not the only syndicate form, see notes 10-14 *infra* and accompanying text, the following figures reflect the minimum volume of syndicate activity.

| | 1959 | 1958 |
|---|--------------|--------------|
| Number of Real Estate Syndicates Filing Certificates of Limited Partnership in N.Y. County Clerk's Office | 142 | 59 |
| Approximate Moneys Solicited From Public Investors | \$72,000,000 | \$35,000,000 |
| Number of Ventures Raising More Than \$1,000,000 | 20 | 10 |

quire or develop an agreed-upon real asset—presently covers property worth upwards of three billion dollars,³ and further increases at the annual rate of at least one billion dollars are expected.⁴ Although a syndicate may consist of a handful of wealthy investors, well-known to one another, and each personally concerned with the operation of the enterprise, the major focus of this Article will be directed towards the widely held venture, whose participants are dependent upon the integrity, judgment, and ability of a syndicate manager for their investment rewards. Often the investor is getting his first taste of real estate investment, and brings to the venture the hopes, fears, and confusion of the dabbler. By contrast, the syndicator usually has “been around”; he has lived in a world where “balloon,” “prime tenant,” and “leaseback” are terms of everyday speech.

Protection of the amateur investor against the risks that may defeat his expectations has been a long-standing aim of governmental regulation. Before examining what state and federal authorities have done to protect the syndicate investor, this Article will examine the risks of real estate investment, both in general and with particular reference to syndication. But first, how does syndication work, who are the investors, and why are they drawn to this form of investment?

SYNDICATION: ITS MECHANICS, ITS CUSTOMERS, AND ITS APPEAL

Before a syndicate is formed, the promoters customarily select the property which the venture will own. A complex of variables may affect this choice.⁵

3. Interview With Louis J. Glickman, N.Y. Realtor, in New York City, Nov. 27, 1959; see Remarks of Albert Mintzer, Founder of SIRE Plan, Inc., Before Overseas Press Club, as reported in *Real Estate Forum*, Nov. 1958, p. 11 (estimate of \$9 billion). See also *The National Real Estate Investor*, March 1960, p. 2 (“dollar volume of syndication will increase 60 percent in 1960”).

4. See *ibid.*

For a general prophesy of syndication's future, see Statement of Louis J. Glickman, Realty, Jan. 19, 1960, p. 3, col. 3 (“1960 will . . . begin . . . an unprecedented growth”). This sentiment recalls a similar spirit of the late 1920's:

Syndicate ownership—

Not so many years ago the term “syndicate” frightened the ordinary man. It sounded like “high finance” and he would have none of it. He is now becoming interested and its advantages are resulting in its use to a considerable extent. It is extremely desirable as a method for operating or speculating in real estate. It enables numerous persons each to take a small share in a project with the result that, should there be a loss, the loss is distributed among the group without resulting in serious financial embarrassment to any one member. . . .

NORTH, VAN BUREN & SMITH, *REAL ESTATE FINANCING* 165-66 (1928).

5. Statement of Marvin Kratter, New York Realtor, to Students at Yale Law School, Nov. 12, 1958. Syndicate promoters are generous donors of “How I Do It” advice. See, e.g., Stern, *Syndicated Investments*, N.Y. Times, Nov. 25, 1956, § 8, p. 1, cols. 6-7; Wien, *How*

The parcel is inspected with an eye to its competitive location, physical condition and the likelihood of future repairs and capital improvements. Accountants or attorneys pore over past operating records, rent schedules and leases, and explore available financing in order to project the property's income and expense potential. The key figure in this projection is the "bottom line"—cash yield after federal incomes taxes. The bottom line is the axis about which negotiations for the parcel will necessarily revolve. Assuming a favorable evaluation, the syndicate manager will then attempt to acquire the property at a price, and upon terms, that will sustain a cash flow to investors at a decided-upon minimum rate.

Should the negotiations culminate in a contract to buy, the promoter will customarily make a deposit—as much as ten per cent of the ultimate purchase price—forfeitable if he does not perform.⁶ This deposit, or option payment, together with expenses of overhead, property acquisition, and promotion, often constitutes a sizeable investment which the promoter hopes to recover when he organizes his syndicate;⁷ the promoter usually retains only a nominal cash investment in the completed transaction although his "paper" interests may

the Syndicate Functions, 14 RECORD N.Y.C.B.A. 51 (1959); Greenblatt, *Real Estate Syndication: Some Basic Considerations*, 14 RECORD N.Y.C.B.A. 65 (1959); Lifton, *How To Organize a Successful Syndication*, The National Real Estate Investor, March 1960, p. 10. For a detailed outline of the factors an investor should consider when buying a building, see Courtney, *Tips From a Pro*, The National Real Estate Investor, March 1960, pp. 18-19.

6. The following are representative of cash deposits made by promoters under purchase contracts for property which they subsequently syndicated.

| | Cash Required by Purchase Contract | Cash Deposit |
|---|---------------------------------------|--------------|
| The Teagen Company Prospectus, Aug. 24, 1959, p. 3 | \$580,000 | \$20,000 |
| Garment Capitol Associates Prospectus, Feb. 13, 1957, p. 7 | \$18,762,750 | \$1,000,000 |
| Brocol Realty Company Brochure, April 1959, p. 8 | \$783,500 | \$50,000 |
| Graybar Building Associates Prospectus, March 10, 1958, p. 6 | \$4,000,000 | \$400,000 |

7. One corporate syndicator estimated its expenses in connection with the syndication of an office building in mid-Manhattan at \$135,000, plus a \$50,000 deposit on the purchase contract. Expenses included fees for legal and accounting services, tax consultation, title insurance, surveys, appraisal and depreciation reports, printing and stenography, advertising and legal publication, and filing and recording. The promoter intended to recover these outlays from the proceeds of a \$1,335,000 public offering. See Brocol Realty Co., Brochure, April 1959, p. 8.

be quite substantial.⁸ Thus, once the participation shares are successfully marketed, the investors bear almost all risk of loss of invested capital.

A variety of forms are available to the syndicate entity. The factors dictating a choice are complex and many are beyond the scope of this Article.⁹ Currently the limited partnership, in which the promoter and his associates are the general partners, is the most favored form.¹⁰ But syndicators have also used the

| 8. | Amount of Offering (Dollars) | Promoter's Cash Investment (Dollars) as Stated in Prospectus |
|-----------------------------|---------------------------------|--|
| Name of Offering | | |
| Graybar Building Associates | 4,180,000 | 20,000 |
| 501 Fifth Realty Company | 2,145,000 | 50,000 |
| Lord Elgin Hotel Company | 1,655,000 | 30,000 |
| Brocol Realty Company | 1,325,000 | 50,000 |

See also *N.Y. Hearings on Real Estate Syndication Before Hon. George Frankenthaler*, Nov. 6, 1957, p. 62, on file in New York City office of New York attorney general.

9. See Aronsohn, *Syndicates*, N.Y.U. 16TH INST. ON FED. TAX. 637 (1958); Pennish, *The Story of Real Estate Syndication*, Tax Counselor's Q., June 1959, p. 111.

Some of the tax factors are examined in the text following note 85 *infra*.

10. See Brudno, *Syndicates and Income Taxation*, in NATIONAL INSTITUTE OF REAL ESTATE BROKERS, *REAL ESTATE SYNDICATES AND HOW THEY WORK* 11, 14 (1957).

In 1959, Marvin Kratter and Robert Futterman left the syndicator ranks when each formed a corporation bearing his name to hold under one umbrella all of the properties he had previously syndicated. See *The Kratter Corp.*, Prospectus, April 24, 1959; Elliott, *Appraising the Syndicates*, Barron's, June 8, 1959, p. 3, at 20; Realty, Jan. 19, 1960, p. 1, cols. 3-5. Perhaps significantly, a third promoter, Louis Glickman, also tried to convert his separate syndicate ventures into a unitary corporation. See *The Glickman Corp.*, Preliminary Prospectus, May 6, 1959. Glickman abandoned the plan when many of his syndicate investors would not accept the conversion. Elliott, *supra* at 3.

The switchover to a real estate operating corporation by two of the most active syndicators (total estimated holdings of Kratter ventures \$50,000,000, see Elliott, *supra* at 3.) may spur imitation; and produce significant changes in the present pattern of public real estate investment.

Whereas the syndicate investor usually depends upon a single property for his investment rewards, the shareholder in a corporation owning many properties "enjoys" risk-spreading. Kratter has described this diversification as of major benefit for its investors. See *The Kratter Corp.*, Release, July 22, 1959. But since the level of overall risk is between that of the least risky and the most risky ventures, some syndicate investors may have actually increased their risk by giving up an interest in a single property. And at least the syndicate investor knows what he owns. The certificates of a corporate shareholder may represent a fractional interest in the Empire State Building on Monday and in a million beer barrels on Tuesday.

A more impressive argument for public corporate investment is the liquidity of the investment unit. See text at notes 55-65 *infra* for a discussion of the liquidity of syndicate interests. For example, shares of *The Kratter Corporation* were listed recently on the American Stock Exchange, see N.Y. Times, March 23, 1960, p. 52, col. 3, and they may be hypothecated at some lending institutions, Address of Marvin Kratter to Yale Law Students, Jan. 13, 1960.

corporation,¹¹ general partnership,¹² tenancy-in-common,¹³ and various hybrid forms.¹⁴

In marketing the investment interests, promoters may rely on sales personnel, independent brokers, or public advertising, as well as mail and direct personal appeals to previous syndicate investors, clients, and friends.¹⁵ As the in-

11. SIRE Post Office Plan, Inc., Amended Offering Circular, Sept. 15, 1959 (investment units, each consisting of one \$50 ten-year, 6% debenture and one \$50 share of the \$3.50 cumulative participating preferred stock); Forest Hills Biscayne Gramercy Corp., Prospectus [undated] (\$5,000 investment units, each consisting of one \$3,960 corporate note and 208 shares of the \$5 par value preferred stock).

12. See, e.g., Warwick Hotel Associates, Prospectus, July 13, 1955 (hotel); Garment Capitol Associates, Prospectus, Feb. 13, 1957 (office building); Leader-Cleveland Realty Associates, Prospectus, Aug. 5, 1958 (office building); Leone 48th St. Associates, Prospectus, Aug. 14, 1959 (restaurant).

Lawrence Wien, Esq., New York Attorney, who promoted these syndications, prefers the general partnership form largely because he feels it is less likely to be treated as a "taxable association" than is a limited partnership. Interview With Henry W. Klein, Esq., Law Partner of Mr. Wien, in New York City, Sept. 22, 1959.

13. See, e.g., Institute for Business Planning, Real Estate Investment Letter, May 6, 1959, p. 67 (Fairfax Building, Kansas City, Mo.).

In the Fairfax Building syndication:

- (1) The promoters held title to the real estate as trustees for the benefit of the investors. The trustees were also to engage in supervisory management, which they characterized as "ministerial."
- (2) 60% consent of the investor coowners was necessary for the sale, transfer, or refinancing of the property.
- (3) Neither the death of an investor nor the transfer of his interest would interrupt the entity.

Whether this arrangement will skirt the "taxable association" crevice is doubtful. In addition to continuity, the venture may also be deemed to have centralized management despite the promoters' description of their supervisory duties as "ministerial." See notes 118-28 *infra* and accompanying text.

For earlier examples of coownership by the syndicate investors, see The Levittown Shopping Center, Unit One, Offering Circular, Aug. 13, 1956; Manqueens SIRE Plan, Inc., Offering Circular, June 14, 1956.

For a brief summary of the possible disadvantages of coownership in the syndicate venture, see Asch, *Tax Considerations in Real Estate Syndication*, 3 VILL. L. REV. 469, 483 (1958).

14. For an example of a syndication combining the sale of interests in a corporation and limited partnership, see Falcaro Associates & Falcaro's East Islip Lanes, Inc., Brochure [undated] (investors offered package deal containing a \$2,000 unit in Associates [limited partnership] and \$1,000 debenture bond in the corporation; Associates to construct a forty-lane bowling alley for operation by corporation under long-term lease).

15. Interview With J. M. Tenney, New York Syndicator, in New York City, Nov. 27, 1959; Interview With Henry Klein, Esq., New York Attorney, in New York City, Sept. 22, 1959.

With each new venture, established promoters are likely to mail a prospectus to investors in earlier syndications. If there are several ground-floor associates, each may have his personal following of family, friends, clients and coinvestors.

To enhance or supplement the response of a mail or direct appeal, syndicator Jerry M.

vestment units are sold, the purchasers execute a subscription agreement and such other documents as are required by the form of the syndicate adopted. The syndicate becomes viable if sufficient funds are raised, via subscription and perhaps supplemented by the promoter's own resources, to acquire the property. If not, subscription payments are either returned¹⁶ or, by agreement, transferred to another venture.¹⁷

The promoter has many sources of profit in a typical syndication. He may receive a brokerage fee from the seller of the property;¹⁸ a profit on the transfer of the property or assignment of the executory sales contract to the syndicate;¹⁹ and promotional underwriting discounts and commissions.²⁰ Should

Tenney described his reliance on staff salesmen, independent brokers, word-of-mouth, and public relations. Tenney's operational pattern seems fairly typical.

Tenney's staff includes several full-time salesmen who follow up a mail solicitation by meeting intending investors and discussing with them the particulars of the proposed venture. Presumably, as salesmen, Tenney's sales personnel are expected to sell.

Tenney has also used several of the approximately twenty-five New York City broker-dealers who specialize in syndicate offerings, and who are registered with the SEC (Securities Exchange Act § 15) and the State of New York (N.Y. GEN. BUS. LAW § 359e). The independent dealer may underwrite a portion of the offering on a "best efforts" basis; he will then try to place his shares through newspaper advertisements or personal contact.

Publicity has for its goal the creation of a favorable public image—that of a successful syndicator. Tenney tries to link his name with syndication in newspaper articles. See, e.g., N.Y. Times, Oct. 12, 1958, § 8 (Real Estate), p. 1, col. 4; *id.*, July 22, 1958, § 8, p. 1, col. 3, and in trade journals directed to brokers, lawyers, and accountants, see, e.g., The National Real Estate Investor, Sept. 1959, p. 1.

16. See Queenstown Gardens, Revised Prospectus, Oct. 28, 1959, p. 2; Dyckman Hotel Associates, Prospectus, Jan. 27, 1959, p. 4; The Teagen Co., Prospectus, Aug. 24, 1959, p. 4.

Occasionally, a promoter agrees to pay interest upon subscription funds from their receipt until they are either invested or returned. See, e.g., 501 Fifth Realty Co., Prospectus, Nov. 12, 1959, pp. 6, 16.

17. For an example, see SIRE Post Office Plan, Inc., Amended Offering Circular, Sept. 15, 1959, p. 7. In order to switch the moneys raised to another venture, the promoter was to send an amended prospectus to the subscriber. The latter could get his money back, if he acted within fifteen days. But in doing so, he would lose part of the interest that his subscription had already earned while it was in the promoter's hands. A combination of human inertia and an unwillingness to suffer the drop in interest income might soften the turn-down rate for the substitute venture.

18. In the syndication of the Levittown Shopping Center, Unit One, one of the promoter's affiliates, Realdeals, Inc., acted as a cooperating broker in negotiating the sale of the property to a second promoter affiliate, The Small Investors Real Estate Plan, Inc. Realdeals, Inc. received one-third of the \$20,000 brokerage paid by the seller. See SIRE Plan, Levittown Shopping Center, Offering Circular, Aug. 13, 1956, p. 13. The second affiliate then received a \$15,000 profit for an assignment of its contractual rights to the syndicate investors. *Id.* at 15.

19. These profits are often substantial, see, e.g., the prospectuses for the following syndicates: Madison-54th Realty Co. [undated], p. 1 (\$100,000); Glen Oaks Shopping Center Realty Co., May 26, 1959, p. 1 (\$200,000); 501 Fifth Realty Co., Nov. 12, 1959, p. 6 (\$375,000), and may take the form of cost-free participation units, see Glen Oaks Shopping Center Realty Co., Brochure, *supra*.

20. SIRE Plan Portfolios, Inc. is the underwriter affiliate of The SIRE Plan, Inc. In

he be an attorney, his office may receive legal fees for handling the transaction, as well as an annual retainer.²¹ Promoters generally share in the property's revenues, either as the operating tenant or as the owner of a participating interest in the syndicate. Realtor promoters may undertake management of the property, thereby earning a management fee.²² Finally, the promoter usually reserves the right to a disproportionate share of any gains from a resale or refinancing of syndicate property.²³

Some syndicators direct their appeal to the small investor. In a recent

a typical SIRE Plan promotion, SIRE Post Office Plan, Inc., offered \$280,000 in its debentures and preferred stock, to finance the purchase of a three-story post-office building. The issuer contracted with SIRE Plan Portfolios, Inc., for a best-efforts promotion of its offering, the underwriter affiliate to receive a 15% commission for its services. In addition, the underwriter bargained for an additional \$22,500 as reimbursement for underwriting expenses, broadly defined to include 7% per annum interest to subscribers during the offering period, printing, mailing, title insurance, legal, accounting, and property acquisition costs. Any moneys not expended were deemed additional compensation to the underwriter. Thus, of the \$280,000 offering proceeds, SIRE Plan Portfolios, Inc., would siphon off \$64,500 (23.3%). SIRE Post Office Plan, Inc., Amended Offering Circular, Sept. 15, 1959, p. 7.

21. The following is a list of legal fees paid to one syndicators' law firm.

| | Paid From Proceeds of Offering | Annual* Retainer |
|------------------------------------|-----------------------------------|---|
| Leone 48th St. Associates | \$115,000 | \$ 9,000 |
| Hotel Taft Associates | —0— | \$90,000 |
| Dyckman Hotel Associates | \$133,500 | \$ 9,000 (until 1967) \$17,750 (until 1973) \$27,000 (1973 & after) |
| Warwick Hotel Associates | \$218,000 | \$21,000 |
| Leader-Cleveland Realty Associates | \$123,000 | \$14,000 |
| Garment Capitol Associates | \$520,000 | \$40,000 |

*The annual retainer covers supervision of the partnership agreement and all regular accounting costs and disbursements.

22. See, *e.g.*, SIRE Post Office Plan, Inc., Amended Offering Circular, Sept. 15, 1959, p. 6 (promoter-affiliate to receive 3% of gross rental); Manqueens SIRE Plan, Inc., Offering Circular, June 14, 1956, p. 16 (promoter-affiliate to receive 5% of rentals); Forest Hills Biscayne Gramercy Corp., Brochure [undated], p. 10.

Promoters may also receive a large per cent of the rental income of the syndicate property above a specified amount. See, *e.g.*, The Levittown SIRE Plan, Prospectus, Aug. 13, 1956, p. 14 (surplus over stated rental payments divided equally between the promoter-affiliate and investors); Forest Hills Biscayne Gramercy Corp., Prospectus [undated], p. 6 (promoter-affiliate makes fixed rental payment to investor, receives all rental income increases to stated amount, 75% of excess above stated amount); Stanbalt Realty Co., Brochure, Dec. 16, 1957, p. 6 (promoter-affiliated lessee makes fixed rental payment to investors; as additional rental, investors receive one-half of lessee's "net earnings (before depreciation and income taxes) from operation of property in excess of \$100,000 per year").

23. See, for example, the following provision contained in Thirty Four Associates, Articles of Limited Partnership, Aug. 1, 1957, p. 3:

9(a) The funds described in paragraph 8, shall be allocated and distributed to each of the partners in the ratio that each partner's number of Capital Units owned

SIRE Plan syndication, for instance, one hundred dollar participations were sold, and the median investment was 1,068 dollars.²⁴ At the other extreme, forty-five presumably well-to-do individuals pooled 4,700,000 dollars to acquire New York City's Hotel Astor, an average investment in excess of 100,000 dollars.²⁵ Most syndicate ventures, however, are far removed from either extreme and involve the sale of five and ten thousand dollar units. An examination of the limited partnership certificates filed in the New York County Clerk's Office during 1958 covering real estate syndicate ventures evidenced the following breakdown:

| <i>Moneys Raised Via Syndication</i> | <i>No. of Syndicates</i> | <i>Average No. of Investors Per Syndicate</i> | <i>Average Investment</i> |
|--|------------------------------|---|-------------------------------|
| \$50,000 and under | 4 | 14 | \$ 2,850 |
| \$50,001-100,000 | 11 | 16 | 5,100 |
| \$100,001-300,000 | 17 | 25 | 7,100 |
| \$300,001-500,000 | 10 | 57 | 7,150 |
| \$500,001-1,000,000 | 7 | 94 | 7,250 |
| \$1,000,001-2,000,000 | 7 | 152 | 10,250 |
| over \$2,000,000 | 3 | 176 | 19,900 |

No comprehensive analysis has been made of the average syndicate investor which attempts to describe his motivation. But tentative conclusions, based upon interviews with syndicate promoters and examination of the few fragmentary statistics now available,²⁶ may be offered. At least three factors enhance the appeal of syndications in the competition for the investor's dollar. First is the comparatively attractive investment yield. A typical syndicate participant expects a ten to twelve per cent annual return during the venture's

bears to the aggregate total of Capital Units owned by all the partners, except as provided in subparagraph 9(b) hereof.

9(b) Notwithstanding the provisions of subparagraph 9(a) above, in the event that the Partnership sells or otherwise disposes of the property, then, any funds available for distribution after such sale or other disposition in excess of \$4,000,000, as defined in paragraph 8 shall be distributed as follows: 20% of such excess funds shall be distributed to . . . [promoter] and the remaining 80% as provided in subparagraph 9(a) hereof.

24. By September 17, 1958, 246 individuals had invested \$262,900 in Preston House SIRE Plan, Inc. The moneys were used to acquire Preston House, an apartment structure in Queens, New York. Appropriately, a Texan made the largest single investment, \$13,700; a few others paid \$5,000 or more for a participation interest. At least ten investors purchased only one \$100 unit. The Preston House subscribers lived in 81 communities in 25 states. Seventeen were members of the U.S. Armed Services. SIRE Plan Portfolios, Inc., Report, Sept. 1958, on file in Yale Law Library.

25. Astor Associates, Certificate of Limited Partnership, filed May 23, 1958, in the N.Y. County Clerk's Office.

26. The most elaborate survey of syndicate investors known to the author was made by the Glickman organization in 1959. Over 3000 individuals who had invested in Glickman-sponsored syndicates received a three-page questionnaire; about 500 (17%) replied. Inter-

formative years.²⁷ Later on, if the property is refinanced upon favorable terms, the yield may increase.²⁸ This reference to yield in describing what the investor receives, however, is frequently misleading for it disguises the fact that

view With Louis Siegal, Vice-President, Glickman Corp., in New York City, Nov. 27, 1959. The replies, in part, are reproduced below:

1. Do you presently own a unit in one or more real estate syndications?

| | |
|---------|----------|
| 7 None | 70 Three |
| 147 One | 51 Four |
| 111 Two | 75 More |

2. If you do, what is the approximate extent of all your real estate syndication investments?

| | |
|----------------------|-----------------------|
| 107 \$2,500-\$ 5,000 | 109 \$15,000-\$35,000 |
| 165 \$5,000-\$15,000 | 66 over \$35,000 |

3. What is your occupation?

| <i>Employed</i> | <i>Self-Employed</i> | |
|----------------------|----------------------|------------|
| 18 Teacher | 30 Medicine | 70 Retired |
| 60 Executive | 9 Law | 45 Other |
| 21 Industrial Worker | 8 Accountant | |
| 27 Office staff | 64 Entrepreneur | |
| 59 Other | 56 Housewife | |

4. What is your approximate age?

| | | |
|-------------|-------------|-----------------|
| 13 Twenties | 156 Fifties | |
| 63 Thirties | 98 Sixties | |
| 113 Forties | 8 Seventies | 13 over Seventy |

7. What is your approximate current income group?

| | |
|-----------------------|----------------------|
| 7 under \$5,000 | 79 \$20,000-\$50,000 |
| 146 \$5,000-\$10,000 | 18 over \$50,000 |
| 145 \$10,000-\$20,000 | |

8. Before buying a syndication unit, did you ever invest in real estate other than ownership of your own home?

| |
|---|
| 96 an income-producing property of your own |
| 72 an income-producing property with partners |
| 23 real estate corporate stock |
| 257 none other |

27. See Helmsley, *Real Estate Syndications*, Analysts J., Feb. 1958, p. 30 (10%-12%); Zukowsky, *Syndicate Surge*, Wall Street Journal, March 4, 1958, p. 1, col. 6 (7%-15%). Among the investors responding to the Glickman questionnaire, see note 26 *supra*, over 60% had received 12% per annum or better in syndicate distributions.

Although the typical syndicate range is as indicated, occasional ventures depart rather sharply from the norm. For example, participants in the syndication of the Desert Inn in Las Vegas will receive a 1% per annum return for three years, 20% per annum during the 4th through 20th years, and 25% per annum thereafter. N.Y. Times, Sept. 20, 1959, § 8 (Real Estate), p. 1, col. 4.

28. For an example of the effect on syndicate yield of mortgage refinancing, see Helmsley, *Brokering to the Upper Brackets*, in NATIONAL INSTITUTE OF REAL ESTATE BROKERS, REAL ESTATE SYNDICATES AND HOW THEY WORK 25, 26 (1957) (distribution raised from 15%-19% per annum).

the return is not entirely "income," but is partially repayment of capital.²⁹ Furthermore, when the income yield is relatively fixed,³⁰ as when syndicate property has been leased on a long-term net-rental basis, the investor bears the risk of declining dollar values.³¹ Even with these qualifications, however, the yield on a syndicate investment exerts a magnetic attraction when compared to the return on most stocks, bonds, mutual funds, and savings accounts.³² In addition, promoters have emphasized that the portion of the yield which represents a return of capital is not taxable when received, a fact which appeals to tax-conscious investors.³³

A second motive for participation in a syndication is the desire for real estate ownership. For some, the enduring quality of real estate suggests a stable, conservative investment.³⁴ For others, the ownership of a landmark which can be readily observed or shown off may bring a psychic satisfaction, even when one's interest is fractionally small. Syndication is a means of satisfying these desires for persons financially unable to acquire full ownership of an equity or unwilling to shoulder the responsibilities of property management. In addition, the wealthier investor, by acquiring interests in several syndicates, may diversify his real-estate portfolio, geographically, functionally, by growth potential, or by degree of risk.³⁵

Finally, the syndicate investor is attracted by the prospects of capital growth. In part, this expectation reflects the historic, long-term increment in land values,³⁶ and the belief that future inflationary pressures will generate further

29. See text at notes 95-97 *infra*.

30. Typically, when the syndicate does not retain its operating position, see text at note 66 *infra*, the investor's return is fixed until the property's income exceeds a stated figure which is considerably greater than its current income, see, e.g., Brocol Realty Co., Brochure, April 1959, p. 5; 501 Fifth Realty Co., Brochure, Nov. 12, 1959, p. 12.

31. See Mortgage Bankers Ass'n of America, Quarterly Economic Report of Trends in the Mortgage Industry, Jan. 27, 1960. This source indicates that a dollar invested in 1940 was worth 48 cents in 1959. Thus a fixed dollar obligation in 1940, which matured in 1960, would have had to bear interest at 3.9% compounded yearly to preserve an investor's capital without any investment return.

32. Alternative investments currently offer the following yields: 125 Industrial Common Stocks—3.26%; 10 High Grade Industrial Preferred Stocks—4.62%; Aaa Industrial Bonds—4.49%. 1960 MOODY'S INDUSTRIALS 1729.

33. See text at notes 95-97 *infra*.

34. Nearly 50% of the Glickman respondents (216) professed faith in the stability of real estate investment. See note 26 *supra*.

35. Marvin Kratter made the argument for diversification in November 1958 when speaking as a syndicator to a forum of Yale Law School students. Mr. Kratter pointed out that an investor who spread \$100,000 among twenty syndicate ventures derived a "mutual fund" benefit when compared with \$100,000 invested in a single property. One year later, speaking in the same forum, but as the spirit of The Kratter Corporation—a multiproperty owner, Kratter asserted that one of his stockholders (at \$17 per share, bid price) had gained the benefit of diversification he could not achieve with a \$5,000 syndicate investment. See note 10 *supra*. Thus, syndication may effect diversification for the well-to-do, the public real estate corporation diversification for the more modest investor.

36. Land values in the United States have increased nearly 800% since 1900. U.S.

price gains.³⁷ Equity growth may also result from the retirement of the mortgage financing with which most syndicated real property improvements are encumbered. As the debt principal recedes, the investors' equity enlarges, provided that real depreciation does not exceed the rate of debt amortization.³⁸

THE PITFALLS OF REAL ESTATE INVESTMENT

In General

Oversupply and Underoccupancy. Economic prosperity is usually evidenced by an upsurge in construction of real estate improvements.³⁹ The lure of construction and operating profits may generate speculative activity among established builders, and attract new entrepreneurs into an industry where entry is relatively easy.⁴⁰ Some evidence exists that this pattern of speculation, as in the twenties,⁴¹ is creating a supply of land improvements which our economy cannot absorb. For example, the post-World War II office building boom in Manhattan will have produced by the end of 1961 over forty-five million square feet of new office space.⁴² Despite a steady rise in vacancies,⁴³ the increased

BUREAU OF THE CENSUS, DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 324 (1959).

37. See Grebler, *The Task Ahead in Real Estate Research*, *The Mortgage Banker*, Dec. 1959, p. 16, at 18-19.

For an example of a promoter's use of the argument that real estate is an anti-inflation hedge, see *The Levittown Shopping Center, Unit One, Offering Circular*, Aug. 13, 1956, p. 12. For a more cautious view, see Fogarty, *Is Real Estate an Inflation Hedge?*, *Architectural F.*, June 1959, p. 155.

38. See, e.g., *The Levittown Shopping Center, Unit One, Offering Circular*, Aug. 13, 1956, p. 7.

39. See generally SHULTZ & SIMMONS, *OFFICES IN THE SKY* 153-63 (1959). For a description of an apparent cyclical pattern in real estate activity, see RATCLIFF, *URBAN LAND ECONOMICS* 338-41 (1949).

40. See Kaplan, *Profile of the Contract Construction Industry*, *Construction Rev.*, Feb. 1957, pp. 4-5, 7-8.

41. Manhattan's office space increased 92% between 1925-1931. The next two years added another 56%, including the Empire State Building and Rockefeller Center. See SHULTZ & SIMMONS, *OFFICES IN THE SKY* 154 (1959).

42. N.Y. Times, Jan. 10, 1960, § 8, p. 4, cols. 2-7.

43. See *id.*, July 1, 1958, p. 53, col. 5; *id.*, May 8, 1959, p. 44, col. 3. *But see id.*, June 20, 1959, p. 32, col. 4 (new buildings will not increase vacancies).

In the year ending April 30, 1958, one million square feet of additional office building quarters became vacant in 387 structures in New York City. During this period, plans were filed for 19 new buildings, having a total capacity of seven million square feet.

| | Vacancy Rate | | |
|--------------|--------------|--------------|--------------|
| | June 1, 1959 | June 1, 1958 | June 1, 1957 |
| Office Bldg. | 2.5% | 2.5% | 1.3% |
| Loft Bldg. | 3.0% | 2.8% | 1.7% |

Figures supplied by Dr. Gordon MacDonald, Director of Research, Real Estate Board of New York, Inc.

bargaining power of prime tenants,⁴⁴ and the expressed concern of informed observers,⁴⁵ an additional twenty-five office buildings are already projected for completion beginning in 1962.⁴⁶ And, because the completion of newly constructed major buildings ordinarily lags behind the planning stage by several years, a sharp downward shift in demand during the construction period will either have no effect on the completion of the building, thus aggravating the existing oversupply, or lead to a frequently more costly alternative, abandonment of the project.

Obsolescence. Combined with, and perhaps a partial cause of, oversupply is the rapid technological advance that has transformed the face and interior of the American building within a generation. Air conditioning, high-speed self-service elevators, fluorescent lighting, automatic heating systems, innovations in structural materials and designs, and rapidly changing concepts of interior decoration are hastening the obsolescence of existing improvements.⁴⁷ The first pinch of an oversupply is felt by the older facilities, whose owners must either modernize or expect a lowering of tenant quality and a relative drop in rental income.⁴⁸ Moreover, modernization is often very costly.⁴⁹

Undesirable Location. The immobility of real estate highlights the importance of suitable location. Population trends, availability of parking, access to private and public transportation, physical condition of the surrounding neighborhood, changes in the traveling and shopping habits of the consuming public, a shifting of the center of business or industrial activity, the proximity and quality of competition, the impact of urban renewal programs, directly affect

44. See N.Y. Times, Jan. 5, 1958, § 8, p. 1, col. 2 ("leasing situation has switched from seller's to buyer's market").

45. See statement of S. Earle Honig, New York City realtor of thirty-years experience, in Barron's, May 16, 1955, p. 20; N.Y. Times, June 24, 1958, p. 52, col. 1.

During an era of tight supply, 1946-1958, when vacancy rate was less than 3%, rental increases matched rising operating costs. If supply loosens, building owners will face gathering tenant resistance to further rental increases, despite steady rise in real property taxes, interest rates, labor expenses, etc.

46. N.Y. Times, Jan. 10, 1960, § 8, p. 4, cols. 2-7 (table). The accompanying article, *id.* § 8, at 1, col. 1, sets a hopeful tone over rental prospects for new Manhattan office buildings, especially when compared with the alarms voiced in 1958 against the backdrop of recession.

47. See Architectural F., Jan. 1960, p. 115.

48. See Realty, Dec. 22, 1959, p. 37, col. 1 ("Modernization now a necessity to keep prime tenants"); N.Y. Hearings on Real Estate Syndication Before Hon. George Frankenthaler, Nov. 6, 1957, p. 70.

49. See Stanbalt Realty Co., Prospectus, Dec. 16, 1957, p. 4 (installation of central air-conditioning system in the fifteen-story Standard Oil Building, Baltimore, Md., cost \$600,000). Architectural F., Jan. 1960, p. 117, describes the modernization program launched by Louis Glickman on the former National Biscuit Co. buildings in midtown Manhattan. Glickman paid \$5 million for the property, and then spent nearly \$4 million in improvements, including elevators, heating, plumbing, sprinkler system, electrical service, and tenant area alterations. Glickman organized a syndicate in June 1959 to raise \$4.4 million from public investors to own and operate the property. See Industry City Realty Co., Certificate of Limited Partnership, filed N.Y. County Clerk's Office, June 5, 1959.

the investment quality of real property. Adverse developments, as well as beneficial ones, may occur with comparative suddenness. For example, the recently fashionable apartment houses on Manhattan's upper West Side are being surrounded by a rapidly deteriorating blighted area⁵⁰ while Third Avenue, for years the domain of pawn shops and grog shops, is now a highly desirable commercial and residential artery.⁵¹

Management. The profitable ownership of investment-type real estate is largely dependent upon management skill.⁵² The ability to curb expenditures without curtailing services, the knack of obtaining tenants and negotiating desirable leases, the adroit handling of complex human relationships—landlord-tenant, employer-employee, taxpayer-municipal authority—and sound judgment whether to make or defer capital improvements is a partial catalog of needed managerial skills. Even an investment in prime real estate becomes risky without able management. Furthermore, once a property has been tarnished by poor management, the stigma may linger in the view of prospective tenants long after a satisfactory change has been effected.

Financing. Most of the improved nonresidential real estate in the United States is encumbered by mortgage debt.⁵³ Because debt service is often a major expense item,⁵⁴ the attractiveness of property for the prospective investor may hinge upon its financing structure. Factors relevant to any analysis include interest and amortization rate, maturity of the debt, identity of the lender, extent of personal liability, restrictions on the operation of the premises incorporated in the mortgage indenture, absence or presence of secondary financing, and privileges of prepayment. In addition, the likelihood of obtaining debt refinancing can be of major import; if the existing debt is not self-liquidating, it may not be replaceable, either in amount or in terms, at or before maturity.

Risks Peculiar to Syndication

Nonliquidity of the Investment Interest. The liquidity of an investment is the ease with which it is convertible into cash or other acceptable medium without shrinkage in value.⁵⁵ Syndicate interests do not meet this description. This fact stems partly from the absence of a formal secondary market which causes

50. See N.Y. Times, July 26, 1959, § 4 (News of the Week), p. 7, cols. 3-4 (map showing New York City slums).

51. *Id.*, Oct. 19, 1958, § 8, p. 1, col. 2, at 5, col. 1; *id.*, Feb. 7, 1960, § 8, p. 1, col. 2; Realty, Dec. 22, 1959, p. 14, col. 1 (some land prices along Third Avenue have jumped from less than \$10.00 to over \$100.00 per square foot in ten years).

52. See CASE, MODERN REAL ESTATE PRACTICE 336-53 (1956); BLISS & SILL, REAL ESTATE MANAGEMENT (1950).

53. See Mortgage Bankers Ass'n of America, Quarterly Economic Report of Trends in the Mortgage Industry, Jan. 27, 1960, p. 1.

54. See, e.g., Leader-Cleveland Realty Associates, Prospectus, Aug. 5, 1958, pp. 6, 12 (30%); SIRE Plan, Inc., The Levittown Shopping Center, Unit One, Offering Circular, Aug. 13, 1956, p. 8 (38%); The Teagen Co., Prospectus, Aug. 24, 1959, p. 11 (48%).

55. See generally 9 ENCYC. SOC. SCI. 491-95 (1933).

the syndicate investor wanting to dispose of his interest to invoke his own resources in the effort to find an interested buyer.⁵⁶ To some extent syndicate managers have assisted in locating buyers, and a few promoters actively maintain an informal market in their securities, both as a convenience and to help preserve investor morale.⁵⁷ But these arrangements are temporary accommodations, and no assurance exists that they will be continued.

Quite commonly, one other factor vitally affects the liquidity of a syndicate investment—a restriction upon its free alienability.⁵⁸ While the nature of the restraint varies with the syndicate, if one exists it is typically cast in one of the following forms: the transfer of an investment interest must be to a member of a recognized class;⁵⁹ the transferee must be approved by the syndicate

56. See Barron's, May 16, 1955, pp. 3, 20; Frankenthaler, Report to [N.Y.] Attorney General Louis Lefkowitz, Feb. 17, 1958, copy on file in Yale Law Library.

The New York Real Estate Securities Exchange, Inc., an exchange specializing in real estate securities, enjoyed a brief existence about thirty years ago. See Address by Cyrus C. Miller, President, N.Y. Real Estate Securities Exchange, Inc., June 27, 1929, on file in the New York City Public Library. For a statement of the Exchange's purposes, see its Directory published Sept. 17, 1938, on file in the New York City Public Library.

57. Real estate syndicators interviewed stated that they have noted little selling pressure for their units, and that the offered interests have been readily marketed. They advance the following reasons: (1) present investors are content since returns have been paid as projected; (2) few investors are pressed for cash; (3) capital gains taxes deplete sales proceeds where the adjusted cost basis is lower than the sales price because of prior returns of capital distributions; (4) the higher yield older ventures exert a strong attraction for outsider investment dollars. All those interviewed agreed, however, that the experience of the past few years is no guide to the demand for syndicate units in the event of a significant downward change in the economy.

See also The National Real Estate Investor, March 1960, p. 20 (independent firm opens New York City office to "maintain a market for syndication interests").

58. UNIFORM LIMITED PARTNERSHIP ACT § 19 permits a limited partner to assign his interest freely; the assignee, however, does not gain the full "privileges" of a limited partner until all remaining members approve him as a substituted limited partner. Until then, he may share in the profits, but may not ask for the inspection of books or an accounting. In most limited-partnership syndicates, only the general partners need consent to a substitution. See, e.g., Motors Building Realty Co., Prospectus, Oct. 21, 1959, p. 11; National Munsey Co., Copartnership Notice, N.Y.L.J., Nov. 6, 1959, p. 17, col. 6. *But see* Thirty Four Associates, Articles of Limited Partnership, Aug. 1, 1957, para. 15(e) (2) (all members must consent).

Whether a potential assignee of a limited partnership interest would consider detrimental the restriction on his becoming a substituted limited partner is an open question. Since his additional rights as a substituted partner matter little unless the venture begins to founder, the would-be buyer, at the time of purchase, may not consider their possible absence a weighty minus factor.

59. See, Motors Building Realty Co., Prospectus, Oct. 21, 1959, p. 11 ("any competent person 21 years of age or older"); Garment Capitol Associates, Prospectus, Feb. 13, 1957, p. 10 ("any individual of full age"); Davidson Court Associates, Copartnership Notice, N.Y.L.J., Feb. 1, 1960, p. 16, col. 1 ("interest cannot be transferred to a . . . [non] resident of the State of New York"); Springfield Motel Co., Copartnership Notice, N.Y.L.J., Nov. 13, 1959, p. 17, col. 4 ("spouse, child, or trustee for spouse or child").

manager;⁶⁰ the nonselling interests reserve the right of first refusal.⁶¹ Express restraints on alienability are more likely to attend the noncorporate form of syndicate entity, for by reducing the transferability of an investor interest, the promoter hopes to forestall or blunt a later-day effort by the Internal Revenue Service to label the syndicate a "taxable association."⁶² But the restraint may also appear in a context devoid of tax consequence if, for example, the promoter simply wishes to be choosy about the identity of his investor associates.

For credit purposes, the collateral value of a noncorporate syndicate interest is extremely limited. Some have said that a syndicate interest will never be accepted as collateral by banks,⁶³ and it is doubtful whether, at the present time, any New York bank will evaluate a prospective borrower's syndicate participation unit for more than a small per cent of its value. In comparison, the maximum loan-to-value ratio for high grade common stocks is approximately seventy per cent, and for Aaa municipal bonds ninety per cent.⁶⁴ Some evidence indicates that private money lenders will accept a syndicate interest

60. A limited partner may sell, assign or transfer his interest to any competent natural person of full age, including the other limited or general partners, at any time, with the consent of the general partners, which consent will not be refused unreasonably.

The Teagen Co., Prospectus, Aug. 24, 1959, p. 9.

61. See, e.g., the restriction set forth in Thirty Four Associates, Articles of Limited Partnership, Aug. 1, 1957, pp. 7-8:

15. Each of the Partners agrees that he will not sell, transfer, assign, pledge, encumber, mortgage, or otherwise dispose of the whole or any part of his interest in the Partnership without complying with the provision of this paragraph 15.

(a) In the event that any Partner shall desire to sell, and shall receive a bona fide written offer for, the whole or any part of his interest in the Partnership . . . such Selling Party shall send a copy of such offer by certified mail to all of the Partners, other than the Selling Party. Such offer shall thereupon be deemed to be an offer by the Selling Party to sell to the other Partners . . . the interest offered upon the same terms and conditions as contained in the offer received by the Selling Party.

Transfers to members of the immediate family, as defined, are excluded from the restriction. *Id.* § 15(b). Furthermore, the general partners may, if in their sole discretion they decide that the Partnership and other Partners would not be injured, permit free assignability. *Id.* § 15(c).

An assignee does not, however, become a substituted Limited Partner without unanimous approval of the Partnership members. *Id.* § 15(e) (2). An assignee, who is not a substituted limited partner, receives distributions on his investment; but may not take part, even to the slight extent available, in the entity affairs. *Id.* § 15(e) (1); see note 58 *supra*.

62. See *N.Y. Hearings on Real Estate Syndication Before Hon. George Frankenthaler*, Nov. 18, 1957, p. 23a; Aronsohn, *Syndicates*, N.Y.U. 16TH INST. ON FED. TAX. 637, 644 (1958). See also text at notes 104-128 *infra*.

63. Interview With Louis Glickman, New York Syndicator, in New York City, Nov. 27, 1959; Address by Marvin Kratter, New York Syndicator, to Students of Yale Law School, Nov. 12, 1958.

64. Interview With M. S. MacDonald, Vice-President, Irving Trust Company, in New York City, March 2, 1960.

hypothecation at ratios more nearly approaching full value but at a higher interest rate.⁶⁵

Since liquidity is absent, the purchase of a syndicate interest as a possible short-term investment is unwarranted. Instead, the syndicate investor should be financially able to ride his choice to the finish line, particularly if the footing becomes heavy.

Lack of investor control. With few exceptions, the syndicate investor does not participate actively, either in the management of the property, or in the decisions made by the syndicate entity. For most investors, the elimination of direct management responsibility is welcomed; very few have both the time and requisite skill. The management arrangements, however, do concern every investor; for a successful syndicate venture depends upon someone's ability to work the property to its maximum yield.

The syndicate seldom retains the direct management responsibility—the “operating position”—in the property which it owns. Rather, it usually leases its property on a long-term net rental basis, the amount of the rent being tailored to produce an annual distribution to the investors at the yield advertised in the offering.⁶⁶ The syndicate promoter, his wholly-owned affiliate, or a second syndicate group also under his control quite frequently takes the operating position by becoming the tenant or subtenant of the syndicate entity.⁶⁷ Alternatively the syndicate entity may enter into a lease or sublease with an unaffiliated concern: most likely a former owner of the property who has engineered a sale-leaseback transaction.⁶⁸ Because the lease or sublease is ordinarily a long-term, net-rental instrument, effective control or management of the property rests with the tenant. In its practical effect, the position of the syndicate investor can be analogized to that of the tenant's bondholders. In these circumstances, both the credit status of the tenant and the conditions of the tenancy—the lease provisions for rent increases or overages, renewals, termination, assignment, fire damage, condemnation—become highly significant.

When the promoter wishes to retain the operating position, he rarely assumes personal liability for the rental payment.⁶⁹ Should the property fail to

65. Address by Marvin Kratter to Students of Yale Law School, Nov. 12, 1958; Interview With Louis Glickman, New York Syndicator, in New York City, Nov. 27, 1959.

66. See Warwick Hotel Associates, Prospectus, July 13, 1955, pp. 10-11; Motors Building Realty Co., Prospectus, June 3, 1958, p. 8; 501 Fifth Realty Co., Brochure, Nov. 12, 1959, p. 8.

67. For the promoter as the tenant or subtenant of the syndicate group, see Stanbalt Realty Co., Brochure, Dec. 16, 1957, p. 6; Hotel Taft Associates, Prospectus, Jan. 2, 1958, pp. 7-8 (second syndicate organized by promoter became the operating lessee).

68. For example, Pratney Associates, a Kratter syndicate, was the buyer-lessor in a 1957 transaction with Pratt & Whitney Company, Inc., where the industrial concern sold and leased back its manufacturing and office site in West Hartford, Conn. The Kratter Corp., Prospectus, April 24, 1959, pp. 23-24.

69. See, e.g., Brocol Realty Co., Brochure, April 1959, p. 10 (promoter-affiliated corporation is net-lessee); 501 Fifth Realty Co., Brochure, Nov. 12, 1959, p. 12 (same); Man-

produce sufficient income, the promoter-lessee ordinarily reserves the right either to reduce the net rental payment or to terminate the lease unilaterally.⁷⁰ In the event the lease is so terminated, the investors may be confronted with the unexpected burden of undertaking new arrangements for the property's management, presumably at a time when the going is rough.

Even when the syndicate entity retains the operating position, the promoter may arrange to manage the property at an agreed-upon fee or percentage for his services.⁷¹ Sometimes the syndicate hires an independent real estate concern.⁷² In contrast with promoter management, a real estate firm may offer know-how, financial responsibility, and previous familiarity with the property. As offsetting factors, however, outside management lacks the promoter's incentive to maximize rentals and syndicate profits and may also be torn by conflicts of interest based upon its similar duties in regard to competing properties.

Not only is the syndicate investor a nonparticipant in the property management, but he may have little or no voice in the decisionmaking process of the syndicate entity. These decisions include the making of management or rental arrangements, borrowing, refinancing, the amount and timing of distributions, the appointment of accountants and of counsel, selection of the controlling group, reframing the organizational mode and the acquisition or sale of property.

In part, the degree of investor control derives from the legal form of the syndicate entity. If a limited partnership has been created, the rights of a limited partner are circumscribed by the particular jurisdiction's version of section 10 of the Uniform Limited Partnership Act.⁷³ He may examine the company's books, count his profits, obtain an accounting and seek dissolution;

queens SIRE Plan, Inc., Offering Circular, June 14, 1956, pp. 7, 16 (same). See also Garment Capitol Associates, Prospectus, Feb. 13, 1957, p. 3 (lessee promoters assume personal liability for first 3 years of 25 year lease).

70. Fairly typical is the arrangement connected with the syndication of the General Motors Building (N.Y.C.) leasehold. The investors purchased the leasehold from the Glickman Corp. of Nevada, then subleased the building back to the Glickman concern under a sublease having a term and renewal option similar to the ones in the leasehold. The sublessee promoter-affiliate agreed to pay the investors a fixed annual rental, and undertook all costs of operation and maintenance, including ground rental. But the sublessee reserved the privilege of assigning the sublease, or "surrendering same to the Partnership on 60 days notice," without further liability. Motors Building Realty Co., Prospectus, June 3, 1958, p. 10.

71. For examples of management by the promoter's affiliate where the syndicate group retains the operating position, see The Teagen Co., Prospectus, Aug. 24, 1959, p. 8; SIRE Post Office Plan, Inc., Amended Offering Circular, Sept. 15, 1959, p. 6.

72. See National Munsey Co., Prospectus, Nov. 20, 1959, p. 7 (management company awarded ten year contract at 3% of gross rentals).

73. See, e.g., N.Y. PARTNERSHIP LAW § 99; N.J. STAT. ANN. § 42:2-14 (Supp. 1959); CAL. CORP. CODE ANN. § 15510. Thirty-nine states have enacted the Uniform Limited Partnership Act. See 8 UNIFORM LAWS ANN. 7 (Supp. 1959).

the exercise of greater rights may transform his status to that of a general partner⁷⁴ and expose him to unlimited liability.

The corporate form of syndicate venture does not appreciably increase investor control. Typically, the corporate investor acquires a combination of debentures and nonvoting preferred stock.⁷⁵ All of the voting power rests in the few shares of common stock held solely by the syndicate promoter.⁷⁶ Only in the event of a protracted default in the payment of debenture interest and preferred stock dividends do the voting rights, and thereby control, shift to the investor.⁷⁷

The use of the general partnership, in which the general partner divides his interest among the syndicate investors who then participate with him as joint venturers,⁷⁸ can offer the investor a somewhat higher level of control. In-

74. For the view that a limited partner may make suggestions and state opinions as to business conduct without assuming a general partner's liability, see, *e.g.*, *Silvola v. Rowlett*, 129 Colo. 522, 272 P.2d 287 (1954); *Skolny v. Richter*, 139 App. Div. 534, 124 N.Y. Supp. 152 (1910). How far a limited partner may go in offering "advice" is unclear. Compare *Grainger v. Antoyan*, 48 Cal. 2d 805, 313 P.2d 848 (1957), with *Holzman v. De Escamilla*, 86 Cal. App. 2d 858, 195 P.2d 833 (Dist. Ct. App. 1948).

Although the general partners have the right to make the decision unilaterally, they sometimes represent that they do not intend to sell partnership property without written approval of a stated percentage of the limited partnership interests. See *Glen Oaks Shopping Center Realty Co.*, Brochure, May 26, 1959, p. 13 (80%); *Lord Elgin Hotel Co.*, Prospectus, Aug. 28, 1958, p. 10 (65%).

75. See *SIRE Post Office Plan, Inc.*, Amended Offering Circular, Sept. 15, 1959, p. 5 (investment package consisting of one \$50 debenture bearing 7% interest and one share of \$3.50 cumulative preferred stock selling for \$50).

76. *Id.* at 10-11. Aside from the possible loss of voting control discussed in note 77 *infra*, the common stockholders accepted a potential limit on their exclusive right to make a proposed sale, leasehold, merger, consolidation, or increased capitalization. If a majority of the preferred stockholders do not approve the proposal and at least one-third of the preferred stockholders state their disapproval in writing after notice, the action is blocked.

Holders of one-third or more of the debentures may similarly block the incurring of certain corporate obligations, unless the borrowings are for (a) "corporate purposes," (b) reduction of the outstanding debentures, or (c) mortgage refinancing. Note that the preferred stockholders as preferred stockholders do not receive even this narrowed privilege, perhaps because of the fear that a court might construe the granting of limited voting power as a grant of the voting powers provided for in N.Y. STOCK CORP. LAW § 16 (two-thirds of a corporation's stockholders entitled to vote must consent to a mortgage of corporate realty).

77. *SIRE Post Office Plan, Inc.*, Amended Offering Circular, Sept. 15, 1959, p. 10. The preferred stockholders may elect a majority of directors if the corporation fails to pay or "set aside and provide for" preferred stock dividends for any two consecutive years. When all arrears have been fully paid or set aside for payment, the voting rights revert to the common stockholders. Query: What does "set aside and provide for" mean?

78. Lawrence Wien, a New York attorney, has been the leading enthusiast for the general partnership mode of real estate syndication. A typical Wien venture was the 1958 purchase of Cleveland's Leader Building for more than four million dollars. Wien and his law partner, William Purcell, formed a general partnership, Leader-Cleveland Realty Associates. The two ground-floor partners each invested \$10,000 and received a one-half interest. Together they raised an additional \$1,280,000 on a public offering; an existing mortgage

vestor control, however, is usually limited by the partnership agreement, which delegates the ultimate decisionmaking power to the promoter partner *as agent* for the investor partners.⁷⁹ In this capacity, the promoter needs investor consent only for stated major decisions, such as lease or mortgage modification or the sale, transfer, and mortgaging of the property. Furthermore, this semblance of residual investor control over major policy is rendered somewhat illusory; for if most of the partners approve the proposal the promoter usually has the right to reacquire the interests of the nonconsenting investors.⁸⁰ And the "buy-out" price, normally original cost less previous capital distributions, does not reflect any increment in the equity value of the investment interest.⁸¹ Thus, the pressure of a forced sale upon potentially undesirable terms undercuts the likelihood that an investor will assert himself.

Where does this leave the syndicate promoter? Except for the minimal limitations to which he may agree, he retains almost exclusive power, regard-

financed the remaining purchase price. Each public investor, as he acquired an interest in Leader-Cleveland Realty Associates, became a joint venturer with either Wien or Purcell. As joint venturers with a general partner, the investors were individually responsible for the full amount of partnership liabilities. Leader-Cleveland Realty Associates, Prospectus, Aug. 5, 1958, pp. 3, 7. Although the investors agree to a contingent risk not present in the limited partnership or corporate format, Mr. Wien feels that the fact of unlimited liability of all investors may help insulate his ventures from "taxable association" treatment. See note 12 *supra*; text at notes 114-17 *infra*. The risk may be a token one. The syndicate participants are not personally liable on the mortgage debt, and many of the other exposures—*e.g.*, fire, tort liability, workmen's compensation, are insurable. In addition, by making a net lease, the syndicate transfers to the operating tenant liability for operating expenses.

79. See Warwick Hotel Associates, Prospectus, July 13, 1955, pp. 8-9; Leader-Cleveland Realty Associates, Prospectus, Aug. 5, 1958, pp. 8-9. The Wien coventurers, see note 78 *supra*, are given the right to remove an agent by the written direction of participants owning at least three-fourths of the agent's interest. However, the displaced agent would be succeeded by nominees previously selected by the ground-floor partners. See note 84 *infra*.

80. See Warwick Hotel Associates, Prospectus, July 13, 1955, p. 8. In his earlier ventures, Wien's ground-floor partners, see notes 86, 87 *supra*, needed 90% approval from each group of joint-venture investors to effect major decisions. *Ibid.* The requisite percentage is now 80%. See Leader-Cleveland Realty Associates, Prospectus, Aug. 5, 1958, p. 8. Contrast this with the two-thirds stockholders' approval required for certain sales or mortgages of corporate real estate under N.Y. STOCK CORP. LAW § 20. The difference may have relevance in distinguishing a Wien general partnership from an association taxable as a corporation. See text at notes 118-28 *infra*.

81. See Leader-Cleveland Realty Associates, Prospectus, Aug. 5, 1958, p. 8. If the distributions projected in this prospectus are realized and accorded the expected tax treatment, after five years each investor will have received approximately \$2,500 in nontaxable distributions per \$10,000 unit. *Id.* at 10. (The Internal Revenue Code treats this distribution as a return of capital which the taxpayer must deduct from his adjusted cost basis. See notes 95, 96 *infra*; INT. REV. CODE OF 1954, § 301(c)(2).) Should an investor then disapprove a planned sale, refinancing, etc., and not less than 80% of the investors in each joint venture group accepted the plan, the general partners could buy back the \$10,000 unit for \$7,500.

In addition, after the forced sale, if he were to recompute what he had earned on his investment for the five years, the investor would find that his annual return had been about 8%, rather than the 12% projected in the prospectus.

less of the syndicate form, to make all major investment decisions—power which he attempts to justify by claiming that investment decisions must be made swiftly by experienced, centralized personnel.⁸² Even though the promoter's judgment within his authority be unsound, the investor is remediless in damages in the absence of a showing of bad faith, fraud or culpable gross negligence.⁸³ Finally, centralized control is self-perpetuating; for upon a promoter's death, resignation, or legal incompetency, his handpicked coterie, and not the investor, decides whether and how the syndicate entity is to continue.⁸⁴

The Uncertain Haven of "Tax Shelter." Federal income tax considerations pervade every real estate syndication.⁸⁵ Form, capitalization, and internal arrangements, as well as the venture's attractiveness to many investors, depend significantly upon a few provisions in the Internal Revenue Code. In shaping the enterprise, the syndicator customarily seeks to maximize not only the investor's yield, but also the nontaxability of his investment, to furnish "tax shelter" to the investor.⁸⁶ The size of the shelter will depend on the amount of depreciation deductible as an operating expense.⁸⁷ Since depreciation deductions do not reflect actual expenditures, allowing depreciation permits a cash flow to investors in excess of taxable income. This excess is treated as

82. This is the author's inference from interviews during 1959 with six leading New York syndicators.

83. See CRANE, *PARTNERSHIP* § 68, & 368 n.87 (2d ed. 1952). See also *UNIFORM LIMITED PARTNERSHIP ACT* § 9(1).

For the liability of promoters, officers and directors of corporate syndicates, see LATTIN, *CORPORATIONS* §§ 10, 12 (1959).

84. See, e.g., *Motors Building Realty Co.*, Prospectus, Oct. 21, 1959, p. 11:

... [I]n the event of the death, retirement, bankruptcy or incompetency of a General Partner, the Partnership will be dissolved. But the remaining General Partners shall have the right to form a new partnership to conduct the business of the old Partnership on substantially the same terms.

Accord, *Leader-Cleveland Realty Associates*, Prospectus, Aug. 5, 1958, p. 8 ("If the Agent dies, is removed, resigns or is unable to act, he will be succeeded by one of four persons named as successors in each agreement.").

85. See generally Brudno, *Syndicates and Income Taxation*, in *NATIONAL INSTITUTE OF REAL ESTATE BROKERS, REAL ESTATE SYNDICATES AND HOW THEY WORK* 11 (1957); Pennish, *The Story of Real Estate Syndication—Tax Advantages and Disadvantages*, *Tax Counselor's Q.*, June 1959, p. 111; Janin, *The Why and How of Real Estate Syndications: Tax Aspects*, *Prac. Law.*, March 1959, p. 60; Asch, *Tax Considerations in Real Estate Syndication*, 3 *VILL. L. REV.* 469 (1958); Aronsohn, *Syndicates*, *N.Y.U. 16TH INST. ON FED. TAX.* 637 (1958); Casey, *How To Determine Best Form for Real Estate Syndicates To Preserve Tax Advantages*, 7 *J. TAXATION* 328 (1957); Spandorf, *Real Estate Syndicates: How To Organize, Operate and Sell Them for Tax Advantages*, 6 *J. TAXATION* 44 (1957); White, *How To Prevent Real Estate Venture Being Taxed as a Corporation*, 12 *J. TAXATION* 48 (1960); White, *Current Tax Planning in Real Estate Transactions—The Real Estate Syndicate*, *U. So. CAL. 1959 TAX INST.* 851.

86. See *The Levittown Shopping Center, Unit One*, Offering Circular, Aug. 13, 1956, p. 9; *501 Fifth Realty Co.*, Brochure, Nov. 12, 1959, p. 9.

87. See *INT. REV. CODE OF 1954*, § 167.

a tax-free return of capital.⁸⁸ As a countervailing factor, cash outlays for mortgage repayment⁸⁹ and capital improvements⁹⁰ are not deductible when made, despite their drain upon cash resources. Thus, any surplus of depreciation, on the one hand, over debt amortization plus capital expenditures, on the other, creates actual cash receipts greater than, and free from the levy on, net taxable income.⁹¹ And, by affording property owners a choice of depreciation techniques, the Code enables him to manipulate the amount of this tax-free surplus.⁹² In general, syndicate promoters have tended to accelerate depreciation allowances during the venture's infancy,⁹³ thereby maximizing the nontaxable portion of the investment yield at the outset. But the potentiality of tax-sheltered income is solely dependent on the amount deductible as depreciation. Thus, as depreciation is taken and the property's depreciable basis reduced, the property's capacity to give rise to tax-free income decreases.⁹⁴

88. An example of depreciation-generated cash flow, in its simplest form would be:

| | |
|--------------------------------|--------|
| Net Income Before Depreciation | 40,000 |
| Allowance for Depreciation | 40,000 |
| Net Taxable Income | —0— |

Although the taxpayer has no taxable income, its cash supply (omitting mortgage amortization and capital investment) has increased \$40,000 during the taxable period.

89. See 2 P-H 1960 FED. TAX SERV. ¶ 11342.

90. See INT. REV. CODE OF 1954, § 263.

91. The following example, taken from an actual syndicate projection, illustrates the generation of tax-free income.

| | | | |
|--------------------|----------------|------------------|----------------|
| Rental Income | \$337,980 | Rental Income | \$337,980 |
| Deductible | | Cash | |
| Expenses: | | Expenses: | |
| Interest on | | Interest on | |
| Mortgages | \$ 97,639 | Mortgages | \$ 97,639 |
| Miscellaneous | 4,000 | Miscellaneous | 4,000 |
| Depreciation | 166,158 | Mortgage Amor- | |
| | <u>267,797</u> | tization | 60,341 |
| | 267,797 | | <u>161,980</u> |
| | | | 161,980 |
| | | Cash Available | |
| Net Taxable Income | \$ 70,183 | for Distribution | \$176,000 |

The excess of depreciation over mortgage amortization payments, *i.e.*, \$105,817, is free from the income tax levy. 501 Fifth Realty Co., Brochure, Nov. 12, 1959, p. 8.

92. See INT. REV. CODE OF 1954, §§ 167(b)-(c).

93. See, *e.g.*, The Kratter Corp., Prospectus, April 24, 1959, p. 4, reproduced as Appendix I on pages 792-93. Even the use of the more conservative straight-line depreciation is likely to generate tax-free income. See, *e.g.*, Dyckman Hotel Associates, Prospectus, Jan. 27, 1959, p. 9.

94. Promoters are also alert to other tax considerations. See generally Weissbourd, *Tax Planning in Real Estate Transactions*, 37 TAXES 1118 (1959). They seek to avoid double taxation of income by avoiding the corporate form. Although the Code added, in 1958, a partnership election for the corporation having ten or fewer members, the corporate syndicate, if it derives more than 20% of its gross receipts from rental, cannot qualify. INT.

The lure of tax-sheltered income tends to obscure the actual investment reward. The Code deems a distribution from a depreciation reserve a return of invested capital.⁹⁵ The investor, however, frequently equates the annual amount the syndicate pays to him with the income generated by his investment. For example, a syndicate investor who receives an annual payment of

REV. CODE OF 1954, §§ 1371, 1372. A closely knit group of wealthy syndicate investors might actually prefer the corporate form if they are ready to forego periodic distributions. The combination of a corporate tax and a capital-gains tax on a stock sale or § 337 dissolution might be less of a bite than the levy imposed on an individual partner's share of partnership income.

Promoters also seek to generate "paper" operating losses which investors can use as an offset against individual income. Thus, the allowance for depreciation or leasehold amortization may produce a net loss for income tax purposes, even though a cash flow is available for distribution. See, *e.g.*, The Kratter Corp., Prospectus, April 24, 1959, p. 4 (Thirty-Four Associates Syndicate). A partner may report on his individual return, as an offset to other income, his distributive share of partnership loss, to the extent of his adjusted basis. INT. REV. CODE OF 1954, § 704. His basis, however, may include, in addition to the cost of his investment unit, his share of the partnership's mortgage debt, even if he is not personally liable on the mortgage. INT. REV. CODE OF 1954, §§ 752(a), (c). By contrast, current operating losses of a corporation are not deductible on the shareholder's individual return. Any reduction in the shareholder's tax stemming from the corporation's operating losses is generally deferred until sale of stock or liquidation, INT. REV. CODE OF 1954, §§ 301-07, when it may be treated as a capital loss, INT. REV. CODE OF 1954, §§ 1211, 1221-23.

Another means of minimizing taxes is by providing for mortgage refinancings in excess of the amount of the current debt. This excess may be distributable tax-free, since distributions by a partnership not based on the partnership's taxable earnings reduce the partners' adjusted cost basis, and are tax-free until the basis is reduced to zero. Thereafter, the receipt of such distributions will be treated as gain from the sale or exchange of a partnership interest. INT. REV. CODE OF 1954, §§ 731, 733. In contrast, the full amount of such distributions by corporations would be taxable to stockholders as dividends, assuming the corporation had earnings and profits. INT. REV. CODE OF 1954, §§ 301, 316.

Finally, most syndicates seek capital gains treatment, under INT. REV. CODE OF 1954, §§ 1221, 1231, on resales of syndicate property.

Those syndicates which may be characterized as dealers in real estate will realize ordinary income upon disposition of their properties. INT. REV. CODE OF 1954, §§ 1221, 1231(b) (1) (A), (B). *Query*: Under what circumstances will a syndicate be found to be a dealer for income-tax purposes?

Upon the sale of partnership assets, if it is treated as a § 1231 or § 1221 capital gain to the partnership entity, individual investors will pay a capital gains tax, even though they are themselves "dealers" in real estate. INT. REV. CODE OF 1954, § 702(b). Corporate stockholders, on the other hand, pay no tax following a sale of the corporate assets until receipt of the distributions. INT. REV. CODE OF 1954, § 301.

The sale or exchange of a partnership interest by a partner dealing in real estate could result in the recognition of ordinary income. INT. REV. CODE OF 1954, §§ 751(a), (d). This result is also possible when one holds an interest in a collapsible corporation, INT. REV. CODE OF 1954, § 341. See generally Levy, *Real Estate Partnerships*, N.Y.U. 16TH INST. ON FED. TAX. 183, 184, 196-203 (1958).

95. If a distribution is not made out of "earnings and profits" as defined in INT. REV. CODE OF 1954, § 316, it is a return of capital under INT. REV. CODE OF 1954, §§ 301(c) (2)-(3). See BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 131, 138-78 (1959).

1,200 dollars on a 10,000-dollar investment may view his return as a twelve per cent yield, and therefore far superior to, let us say, six per cent interest on a first mortgage investment. If, however, 800 dollars of the syndicate distribution is tax-free, and thereby considered a return of capital, only the remaining 400 dollars would be styled as earnings—a four per cent return on the initial 10,000-dollar investment. Obviously this is well below the twelve per cent “yield” the syndicate promised. Nonetheless, in each succeeding year, the investor’s adjusted cost basis, that is his investment, decreases by the amount of his annual receipts which are tax-free, while his annual receipts remain constant in amount; thus his yield (income: investment) can eventually exceed the anticipated twelve per cent.⁹⁶ Furthermore, even after the syndicate investor has recaptured fully his initial investment, he may, unlike the mortgage investor, continue to get distributions. Finally, syndicators counter the theory that tax-free distributions are really returns of capital and not income generated by the syndicate property by claiming that what the fantasy land of the Code treats as a return of capital is, in the real world, mostly a dividend paid out of income. They argue that only payment generated by that portion of the depreciation deduction which represents actual physical wear and tear is, in an economic sense, a return of capital.⁹⁷

96. The following table illustrates the difference in yields between combined income and return of capital, on the one hand, and income only, on the other. The table is based on projections contained in Motors Building Realty Co., Prospectus, Oct. 21, 1959, p. 9. The offering price, per limited partnership unit, is \$5,000; \$500 (10%) annual distributions of income and return of capital are expected.

| Fiscal Year | Adjusted Cost Basis at Start of Fiscal Year | Income | Return of Capital | Income Rate of Return i.e., Income |
|----------------|---|--------|----------------------|--|
| | | | | Adjusted Cost Basis |
| 1959 | \$5,000 | \$213 | \$287 | 4.26% |
| 1960 | 4,713 | 219 | 281 | 4.65% |
| 1961 | 4,432 | 225 | 275 | 5.08% |
| 1962 | 4,157 | 231 | 269 | 5.56% |
| 1963 | 3,988 | 238 | 262 | 6.12% |
| 1964 | 3,636 | 245 | 255 | 6.75% |
| 1965 | 3,371 | 253 | 247 | 7.51% |
| 1966 | 3,124 | 261 | 239 | 8.35% |
| 1967 | 2,885 | 270 | 230 | 9.36% |
| 1968 | 2,655 | 279 | 221 | 10.51% |
| 1969 | 2,434 | 288 | 212 | 11.83% |
| 1970 | 2,222 | 298 | 202 | 13.41% |
| 1971 | 2,020 | 309 | 191 | 15.30% |

97. Interview With J. M. Tenney, New York Syndicator, in New York City, Nov. 27, 1959.

In painting a bright picture of the yield which syndicate investors will receive, promoters often overlook the facts that the spread between the optimistic income projections and fixed expenses of many syndicated properties is quite small, 501 Fifth Realty Co., Brochure, Nov. 12, 1959, p. 13 (9%); Brocol Realty Co., Brochure, April, 1959, p. 7 (10%); Madison-54th

An additional tax risk for the investor is Internal Revenue Service disallowance of the various components of the depreciation schedule, such as method and rate, estimate of useful asset life, and land-improvement allocation.⁹⁸ Section 167(d) of the Internal Revenue Code offers the promoter an opportunity to minimize this risk, for it authorizes the Secretary of the Treasury or his delegate to execute binding agreements with taxpayers as to the useful life, method and rate of depreciation, and salvage value of any property.⁹⁹ But the basis for depreciation, including land-improvement allocation, cannot be encompassed by agreement, and an unfavorable ruling might await the initial tax return.¹⁰⁰

Accelerated depreciation at the outset of a venture may have untoward tax consequences in the future. Frequently, the imbalance between taxable income and cash income will be reversed after several years of operation. Instead of cash earnings upon which no tax is payable, ventures may accrue taxes upon money already spent for amortization and capital improvements.¹⁰¹ In unincorporated enterprises investors would then have to report as income, and pay taxes on, earnings never received.¹⁰² Perhaps the investor will accept the deferred nature of his liability; but it is more likely that he will expect pro-

Realty Co., Brochure [undated], p. 4 (8%), and even a slight drop in earnings or increase in expenses may reduce the yield on the underlying investment units. Moreover, even if no catastrophic drop in earnings occurs, the investor's anticipated high yield may be cut off, should he dissent from a plan of sale or refinancing approved by most of his coventurers, since at least one large syndicator reserves the privilege to repurchase the dissenter's investment interest at its adjusted cost basis, regardless of its realizable market worth. See, e.g., Hotel Taft Associates, Prospectus, Jan. 2, 1958, p. 9. Nor should the investor forget, when translating yield into rate of return, that if he sells his investment unit, taxes may then be payable on earlier capital distributions which reduced his cost basis. See INT. REV. CODE OF 1954, § 733. The transaction will usually be treated as the sale or exchange of a capital asset held for longer than six months. See INT. REV. CODE OF 1954, § 1221; note 94 *supra*.

98. The burden is on the taxpayer to overcome the presumption of the correctness of the Commissioner's determination. See, e.g., *Pittsburgh Hotels Co. v. Commissioner*, 43 F.2d 345 (3d Cir. 1930), *reversing* 15 B.T.A. 587 (1929).

99. If the taxpayer has an existing agreement covering other property having the "same characteristics," the Commissioner will probably permit the depreciation rate in the agreement to apply to the newly acquired property. See Treas. Reg. § 1.167(d)-1 (1956); 1957-1 CUM. BULL. 737. Compare 2 CCH 1960 STAND. FED. TAX REP. ¶ 1742.05.

100. After the initial return, the danger lessens since it is the policy of the Internal Revenue Service not to disturb depreciation deductions except when there is a clear and convincing basis for a change. Rev. Rul. 90, 1953-1 CUM. BULL. 43.

101. For syndications in which the promoters expect amortization to exceed depreciation, see *The Teagen Co.*, Prospectus, Aug. 24, 1959, p. 12 (after tenth year); *Lord Elgin Hotel Co.*, Prospectus, Aug. 28, 1959, p. 13 (after fifteenth year).

Prior to the crossover point, the portion of nontaxable return of capital in the syndicate distribution declines steadily. *Ibid.* For the investor seeking to sell his participation unit, the decreasingly favorable tax treatment may further impair his liquidity. See text at notes 55-65 *supra*.

102. Each partner must pay tax on his distributive share of partnership income whether or not it is distributed to him. INT. REV. CODE OF 1954, § 702(a).

motors to take some ameliorative action. Several procedures are potentially available: a switch to straight-line depreciation¹⁰³ in order to increase annual deductions, mortgage refinancing to reduce amortization payments, and disposition of the property. None of these is entirely satisfactory, however, and they may not be feasible when action is most desirable.

Although depreciation is the source of tax-sheltered income, the investors' ultimate enjoyment of its benefits may depend upon the promoter's choice of the syndicate's organizational form. For many purposes, the syndicator might prefer incorporation.¹⁰⁴ But the burden of the corporate income tax,¹⁰⁵ the spectre of "collapsible corporation,"¹⁰⁶ and the stockholder's inability to reflect corporate losses upon his personal return, have curtailed widespread use of

103. See INT. REV. CODE OF 1954, § 167(e); Treas. Reg. § 1.167(e)-1 (1956); Rev. Rul. 57-510, 1957-2 CUM. BULL. 152.

The Commissioner's consent is needed for any change in depreciation method, except for a switch from double-declining-balance to straight-line. And even this exception will require consent if the depreciation method was covered by previous agreement. See note 99 *supra*.

The following example illustrates the utility of this approach.

Assume the cost basis of depreciable property, having a useful life of 10 years, is \$100,000. The property produces annual revenue of \$10,000 after mortgage interest and before depreciation. The annual mortgage payments for amortization were \$8,000.

If the double-declining-balance method of depreciation were elected, a rate of 20% would apply. INT. REV. CODE OF 1954, § 167(b)(2); Treas. Reg. § 1.167(b)(2) (1956). This produces the following results:

| Year | Revenues | Amortization | Depreciation Allowed | Cash Yield | Taxable Income |
|---|----------|--------------|-------------------------|------------|-------------------|
| 1 | 10,000 | 8,000 | 20,000 | 2,000 | —0— |
| 2 | 10,000 | 8,000 | 16,000 | 2,000 | —0— |
| 3 | 10,000 | 8,000 | 12,800 | 2,000 | —0— |
| 4 | 10,000 | 8,000 | 10,240 | 2,000 | —0— |
| 5 | 10,000 | 8,000 | 8,192 | 2,000 | 1,808 |
| 6 | 10,000 | 8,000 | 6,554 | 2,000 | 3,446 |
| Switch to Straight-Line Method After 2d Year | | | | | |
| 1 | 10,000 | 8,000 | 20,000 | 2,000 | —0— |
| 2 | 10,000 | 8,000 | 16,000 | 2,000 | —0— |
| 3 | 10,000 | 8,000 | 8,000 | 2,000 | 2,000 |
| 4 | 10,000 | 8,000 | 8,000 | 2,000 | 2,000 |
| 5 | 10,000 | 8,000 | 8,000 | 2,000 | 2,000 |

104. See generally BALLANTINE, CORPORATIONS §§ 1, 2 (1946).

105. The corporation must pay a tax of 30% on the first \$25,000, and 52% on the excess. INT. REV. CODE OF 1954, § 11. Distributions by the corporation are then taxed again to the individual stockholders as dividend income. The stockholders may, however, realize capital gains by the sale of their stock before the dividends are paid. INT. REV. CODE OF 1954, §§ 301, 1221.

106. See INT. REV. CODE OF 1954, § 341. For an excellent and concise analysis of the intricate details of § 341 see BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 10.01-.07 (1959).

the syndicate corporation.¹⁰⁷ Some syndicators have ventured to structure corporations with a high proportion of unsecured debt to stock,¹⁰⁸ thereby reducing taxable corporate income; but the "thin capitalization" doctrine, which treats what seems to be debt as stock, poses a serious threat to this device.¹⁰⁹

Having rejected corporate organization, syndicators usually select either the limited or general partnership. But the partnership form is itself straddled with uncertain tax consequences—an outgrowth of the "taxable association" doctrine. "Association" is a category designed to envelop in the corporate-tax fold those entities which resemble, but are not labeled, corporations. Nearly a generation ago, the United States Supreme Court, in *Morrissey v. Commissioner*,¹¹⁰ branded a business trust a taxable association. In explaining its result, the Court relied on the trust's resemblance to a corporation: (1) title in the entity, (2) limited liability of participants, (3) centralized management acting in a representative capacity, and (4) continuity of existence despite the death of a participant or the transfer of a participating interest.¹¹¹ Later cases made clear that partnerships are included in the thrust of *Morrissey*.¹¹²

What the Supreme Court did not say was whether, in a succeeding case, the absence of any one or more of the *Morrissey* criteria would avoid the "association" label and, conversely, whether the presence of any one or more of the *Morrissey* criteria would necessarily evoke the "association" tag. One safe assertion, in viewing the development of *Morrissey*, is that the first criterion, the fact or nonfact of titleholding in the entity, has little relevance, particularly since the Uniform Partnership Act expressly recognizes the right of any partnership to hold real estate in the partnership name.¹¹³ Commentators have tended also to dismiss limited liability as a significant factor, if at least one investor—*e.g.*, the general partner in a limited partnership—has unlimited liability.¹¹⁴ When every partner's liability is limited, as in the limited partner-

107. See note 94 *supra*.

108. See SIRE Post Office Plan, Inc., Amended Offering Circular, Sept. 15, 1959, p. 5.

109. See *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956), affirming 23 T.C. 408 (1954); *Miller's Estate v. Commissioner*, 239 F.2d 729 (9th Cir. 1956), reversing 24 T.C. 923 (1955); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), reversing 21 T.C. 513 (1954); Comment, *The Thin Incorporation Problem: Are the Courts Fighting the Tar Baby?*, 8 U.C.L.A.L. REV. 275 (1958); Spanbock, Carro & Katz, *Nourishing the Thin Corporation*, 34 TAXES 687 (1956).

110. 296 U.S. 344 (1935).

111. *Id.* at 359.

112. *Kintner v. United States*, 216 F.2d 418 (9th Cir. 1954); *Poplar Bluff Printing Co. v. Commissioner*, 149 F.2d 1016 (8th Cir. 1945). See also *J. A. Riggs Tractor Co.*, 6 T.C. 889 (1946).

113. UNIFORM PARTNERSHIP ACT § 8(3). By 1959, thirty-eight states had enacted uniform partnership legislation. See 7 UNIFORM LAWS ANN. 7 (Supp. 1959).

The limited partnership derives its right to hold real estate in the firm name from § 6(2) of the Uniform Partnership Act which provides "... this act shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith."

114. See Smith, *Associations Classified as Corporations Under the Internal Revenue*

ship association,¹¹⁵ or when a limited partnership's sole general partner is a corporation,¹¹⁶ the corporate resemblance may, however, be conclusive. Even if every investor has unlimited liability, this fact alone may not immunize the venture from "taxable association" treatment.¹¹⁷

The interpretation of *Morrissey* which has taken shape in the literature¹¹⁸ has narrowed the relevant criteria so that a partnership may avoid the "association" label if it lacks either centralized management in a representative capacity or continuity. The commentators, however, have given no content to

Code, 34 CALIF. L. REV. 461, 527 (1946); Levy, *Real Estate Partnerships*, N.Y.U. 16TH INST. ON FED. TAX. 183, 188 (1958); Driscoll, *The Association Problem in Joint Ventures and Limited Partnerships*, N.Y.U. 17TH INST. ON FED. TAX. 1067, 1075 (1959). *But see* Proposed Treas. Regs. §§ 301.7701-1 to -4, 24 Fed. Reg. 10451-55 (1959) (limited liability named as one of major characteristics to distinguish association from partnership).

115. See PA. STAT. ANN. tit. 59, § 241 (1930); MICH. STAT. ANN. § 20.91 (1959); N.J. STAT. ANN. § 42:3-1 (1939); OHIO REV. CODE ANN. § 1783.01 (Page 1953); Giant Auto Parts, Ltd., 13 T.C. 307 (1949) (Ohio limited partnership association held taxable association).

116. A majority of courts have held that corporations do not have the power to become partners, unless expressly authorized to do so by charter or statute. See Annot., 60 A.L.R. 2d 917, 920 (1956) (collecting cases). Most of the cases justify this rule on the rationale that corporation statutes require the exercise of corporate powers by a board of directors, thus precluding a corporation from being bound by outsiders who may be its partners. See, e.g., *Frieda Popkov Corp. v. Stack*, 198 Misc. 826, 103 N.Y.S.2d 507 (Sup. Ct. 1950). The reasoning may not apply to cases where the corporation is the sole general partner. Cf. *Port Arthur Trust Co. v. Muldrow*, 155 Tex. 612, 291 S.W.2d 312 (1956).

117. See *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110 (1925); Proposed Treas. Reg. § 301.7701-2(g), 24 Fed. Reg. 10452 (1959) (in examples (1) and (5) certain ventures are taxed as associations even though each investor has unlimited liability).

Two proposals have been made to relieve both corporated and unincorporated real estate syndicates of the corporate tax burden. One suggestion would extend the subchapter S election, see note 102 *supra*, to corporations deriving more than 20% of their earnings from rental income, see 10 J. TAXATION 19 (1959); National Real Estate Investor, Jan. 1960, p. 23. The change would be of limited benefit since the subchapter S election is available only to businesses having not more than ten shareholders and requires unanimous investor consent. INT. REV. CODE OF 1954, §§ 1371(a), 1372(a).

The second proposal would extend the advantageous tax treatment of regulated investment companies to real estate trusts specializing in real estate equities and mortgages. See S. REP. NO. 1983, 85th Cong., 2d Sess. 65-69 (1958). Regulated investment companies are taxed only on their undistributed income, if they distribute at least 90% of their ordinary income. Capital gains realized by the company are treated as capital gains in the hands of the recipient. INT. REV. CODE OF 1954, § 852. The trust proposal, however, applies only to a passive trust, i.e., a venture not engaged in "active business operations." See S. REP. NO. 1983, *supra* at 68. Although most syndications do not operate their properties directly, see text at note 66 *supra*, and would probably qualify as passive trusts, if the operating tenants were to default and force the syndicate group to take over the reins, the trust treatment would be lost, at least during the period of direct syndicate management. The real estate trust proposal was adopted by the Senate in 1958, but was scrapped by the Conference Committee. Architectural F., Sept. 1958, p. 6.

118. See note 114 *supra*; 7 MERTENS, FEDERAL INCOME TAXATION § 38A.12 (1956) (collecting cases).

these phrases, so that a review of the post-*Morrissey* "association" developments is desirable.

Morrissey was followed by regulations which listed, for several organizational forms, the features necessary to support an "association" finding.¹¹⁹ The relevant language from the limited-partnership regulation reads:

If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, *and* if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. For want of these essential characteristics, a limited partnership is to be considered as an ordinary partnership . . .¹²⁰

Shortly after the regulations were issued, the Board of Tax Appeals decided *Glensder Textile Co.*,¹²¹ which involved a limited partnership formed by four men as a means of bringing their wives into their business, presumably to split taxes. The husbands, who invested five-twelfths of the venture capital, became general partners and retained managerial control. Upon the death of any husband, the partnership was to terminate, although the surviving general partners might reconstitute within thirty days. The limited-partner wives were permitted to assign their interests freely. Against the Commissioner's effort to tax this venture as an association by stressing centralized management and continuity, the Board held that *this* limited partnership was not a taxable entity. Its opinion pointed out that, despite centralized management, the general partners were not acting "merely in a representative capacity," since they (unlike the *Morrissey* trustees) had their own five-twelfths interest to manage as well as that of the silent investors. Furthermore, unlike corporate directors, the general partners could not be voted in or out of office. Nor did the Board, in considering continuity, accept the Commissioner's claim that the venture would survive the death of a general partner. That the remaining general partners would choose to reconstitute was at best a contingency, not at all like the assured life of the *Morrissey* trust or a corporation.

Even though the *Glensder* taxpayers were able to satisfy the Board that their entity did not too closely resemble a corporation, the reliance of both taxpayers and Commissioner upon tests offered in the same set of regulations suggests that the regulations have not been a steady guide for tax planning. As a preliminary inquiry, what predictive value is the regulation's key phrase "[centralized] . . . management . . . in a representative capacity," for a syndicator who wants to retain sole control of the venture while avoiding association status? If the syndicator's personal investment is "substantial," according to

119. Treas. Reg. 103, § 19.3797-3 (1939) (association distinguished from trust); Treas. Reg. 103, § 19.3797-4 (1939) (partnership); Treas. Reg. 103, § 19.3797-5 (1939) (limited partnership); Treas. Reg. 103, § 19.3797-6 (1939) (partnership association).

120. Treas. Reg. 103, § 19.3797-5 (1939), as amended, T.D. 4894, 1939-1 CUM. BULL. 79.

121. 46 B.T.A. 176 (1942), *acq.*, 1942-1 CUM. BULL. 8.

some analyses, he is acting in his own behalf and not representatively.¹²² But what is a "substantial" investment? The *Glensder* general partners had a forty-two per cent investment in their venture, and passed the test. Syndicate promoters, on the other hand, seldom acquire more than a fifteen per cent paper interest in their ventures, and their cash investments are often much lower.¹²³ And what is the relevance of the source of the manager's investment? Will a court deem the promoter's cash investment more substantial than shares based on promotional services or a contract assignment?¹²⁴ Finally, how should a court assess the promoter's override—his potential share, not reflected by his investment, of high property earnings or a profitable resale?

Since the regulations impose a two-fold standard for association status, the doubts raised by "representative management" might be less worrisome if a general partner's death clearly interrupted the venture's existence. But a real estate syndicate cannot feasibly provide for the sale of a large asset upon the chance death of one of the promoters. Thus, syndicates usually arrange for continued existence after a general partner's death.

In spelling out these post-mortem arrangements, the promoter's choice of language may be crucial. If the partnership agreement asserts candidly that "[I]f any of the General Partners die, . . . or become insane, the partnership shall not be deemed to be dissolved. In the event of the death or insanity, all rights, benefits and obligations under this agreement shall pass to the personal representative of said general manager . . .,"¹²⁵ the resemblance to corporate continuity becomes compelling; and, under the *Morrissey* regulations, only the vague "representative management" test would separate the partnership from an association. Not trusting this filmy screen between themselves and corporate taxation, syndicators have sought to devise language that, even as it disavows continuity, also assures the investors that a general partner's death is unlikely to affect the venture's life. This sleight-of-hand draftsmanship often takes the following form:

In the event of the death, retirement, bankruptcy or adjudication of a General Partner, the Partnership *shall* be dissolved or terminated. However, the surviving General Partners, acting unanimously, shall have the right, but not the obligation, to form a new New York Limited Partnership to engage in the same business as the Partnership, and employing the assets and name of Partnership . . .¹²⁶

122. See Driscoll, *The Association Problem in Joint Ventures and Limited Partnerships*, N.Y.U. 17TH INST. ON FED. TAX. 1067, 1084 (1959); Heard, *How To Avoid the Taxation of Limited Partnerships as Corporations*, 6 J. TAXATION 298 (1957).

123. See note 8 *supra* and accompanying text.

124. One author suggests that a contribution of services may be far more valuable to the venture than a capital investment, and cites *Commissioner v. Culbertson*, 337 U.S. 733, 740 (1949). Driscoll, *supra* note 122, at 1085.

125. *Golden Holding Co., Copartnership Notice*, N.Y.L.J., Sept. 15, 1959, p. 16, col. 2.

126. *Madison-54th Realty Co., Copartnership Notice*, N.Y.L.J., Sept. 15, 1959, p. 16, col. 1.

On its face, a general partner's death terminates the entity; yet the reasonable expectation is that the remaining general partners will form a successor firm. Hinging continuity upon the survivors' unanimous consent relies, of course, on *Glensder*, which vitalized the distinction between assured continuity and almost-assured continuity by stressing the free choice of the surviving general partners to continue or not.¹²⁷ But an underlying risk lurks in trying to equate *Glensder* with the typical real estate syndicate. On its facts, the syndicate partnership more closely resembles the *Morrissey* trust than the *Glensder* family group. To pull *Glensder's* language out of context and to apply it automatically to all other limited partnerships may be an act of faith; it may not, however, be an act of wisdom.¹²⁸

127. See 46 B.T.A. at 185.

128. Two years ago, syndicator Louis Glickman obtained a private ruling that Motors Building Realty Company, a limited partnership of nearly 1200 investors formed to acquire the General Motors Building leasehold, would not be taxed as an association. Motors Building Realty Co., Prospectus, June 3, 1958, p. 10. Since the benefits of a private ruling do not radiate beyond its addressee, *Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959), other syndicates cannot bank upon like favorable treatment. Moreover, rulings relative to the association status of individual syndicates are not presently obtainable. 108 J. ACCOUNTANCY 77 (1959). And the Service is now challenging the taxability of real estate syndicates organized as general partnerships in three pending cases. White, *How To Prevent Real Estate Venture Being Taxed as a Corporation*, 12 J. TAXATION 48 (1960).

The Service has recently issued proposed regulations in another attempt to un muddy the association waters. Proposed Treas. Regs. §§ 301.7701-1 to -4, 24 Fed. Reg. 10451-55 (1959). A public hearing to discuss the proposals took place in Washington on February 25, 1960. The National Real Estate Investor, March 1960, p. 23.

The proposals state reminiscently:

An organization will be treated as an Association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust. See *Morrissey et al. v. Commissioner* (1935) 296 U.S. 344.

Proposed Treas. Reg. § 301.7701-2, 24 Fed. Reg. 10451 (1959).

Characteristics cited as material in distinguishing an association from a partnership are most of the old standbys: (1) continuity of life; (2) centralized management (but note: "in a representative capacity" is omitted); (3) limited liability; and (4) free transferability of interests. But each of these is described in fuller detail than has been done by previous regulations or the courts.

The Service suggests that it will scrutinize a partnership entity for each of the four elements. Where these are present in various combinations, the entity will be treated as an association. The proposed regulations then set forth a number of detailed examples to illustrate what elements, separately or in combination, are regarded by the Service as preserving the partnership or creating association status.

Although the expanded definitions, together with the examples, may help the syndicate promoter chart his course between partnership and association, the hoped-for precision and predictability has not resulted.

In the first place, the detailed tests, while dispersing some old clouded issues, may have gathered new ones. For example, the proposals would seem to resolve the uncertainty over the corporate resemblance of a limited partnership's management, see text following note 121 *supra*, by characterizing the management of any limited partnership as centralized by its "very nature." On the other hand, the Service suggests that a limited partnership may avoid "limited liability" if at least one partner has both personal liability and "substantial

THE NEED FOR REGULATION

The much-publicized Nassau Management affair¹²⁹ demonstrates the erosive effect of unsound property selection and inadequate property management upon investor's expectations.¹³⁰ Organized in 1952 to engage in urban renewal projects and property management,¹³¹ Nassau Management Company later ventured into syndication. Typical of its syndications was the raising in 1957 of 1,250,000 dollars to purchase the Concourse Plaza Hotel in the Bronx.¹³² The investment group formed The Concourse Plaza Company, a limited partnership, in which the Nassau promoters were the general partners, with two

assets." But what are substantial assets? And when are these measured? At the venture's formation or during each taxable year thereafter? Even more troublesome is the vagueness of the test for "continuity of life." Although the Service devotes three paragraphs to explain continuity, it has done little more than hinge continuity upon whether, under state law, the general partner's death or withdrawal will "dissolve" the entity. But the state law for a limited partnership, as an instance, is usually the Uniform Limited Partnership Act; and § 20 of the uniform act, speaking to the issue of dissolution, provides that the "retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners." Is it enough, in order for a limited partnership to escape continuity, to provide in its certificate that a general partner's death *shall* cause dissolution, but that the surviving general partners may elect to continue the business. See the text at note 126 *supra* for a common example of this language. If the survivors' election to continue is binding on the limited partners, then, despite the certificate language, it is difficult to see how dissolution has taken place in any meaningful sense. For dissolution to occur, the limited partners who do not wish to join the "new" entity should be permitted to assert a claim against the "old" entity for their proportionate share of the partnership assets. And at least one recently formed limited-partnership syndicate perhaps in anticipation of the proposed regulations has apparently adopted this view by agreeing to purchase at its appraised value the interest of any limited partner who chooses to drop out when the business is continued after a general partner's death. See 501 Fifth Realty Co., Brochure, Nov. 12, 1959, p. 8.

Even if the detailed tests were clearer, the examples given in the proposed Regulations to suggest what combinations of elements will constitute either an association or partnership cover only a portion of the possible combinations. The examples assert that centralized management and a modified form of free transferability accompanied by either limited liability or continuity of life will invoke association treatment. But they leave unanswered the effect of one of the former with one of the latter. Nor do they suggest the effect of continuity alone, or when it is accompanied by limited liability.

129. See N.Y. Times, Jan. 23, 1958, p. 1, col. 4; *id.*, Jan. 24, 1958, p. 25, col. 1; *id.*, Jan. 25, 1958, p. 40, col. 4; *id.*, Jan. 26, 1958, § 8, p. 1, col. 8; *id.*, Jan. 28, 1958, p. 56, col. 1; *id.*, Jan. 29, 1958, p. 5, col. 7; *id.*, Jan. 31, 1958, p. 42, col. 4; *id.*, Feb. 1, 1958, p. 7, col. 2; *id.*, Feb. 3, 1958, p. 15, col. 6; *id.*, Feb. 4, 1958, p. 31, col. 3; *id.*, Feb. 5, 1958, p. 18, col. 2; *id.*, Feb. 8, 1958, p. 21, col. 1; *id.*, Feb. 21, 1958, p. 15, col. 2; *id.*, March 16, 1958, § 1, p. 1, col. 5; *id.*, June 6, 1958, p. 1, col. 1; *id.*, Dec. 17, 1959, p. 20, col. 5.

130. From time to time, observers have voiced alarms about the soundness of syndication. See, e.g., the statement of Henry Rice, Vice-Pres. of James Felt & Co.: "A potentially explosive situation has resulted from the activities of a small minority of real estate promoters . . . [O]nly continued rise in realty values has prevented marginal syndicators from collapsing." Realty, Jan. 19, 1960, p. 1, col. 4.

131. N.Y. Times, Jan. 24, 1958, p. 25, col. 1.

132. *Id.*, Jan. 23, 1958, p. 1, col. 4, at 18, col. 4.

hundred and fifty subscribers as limited partners.¹³³ The syndicate acquired title to the Concourse Plaza, and executed a simultaneous leaseback to a promoter-owned dummy management company.¹³⁴ Under the lease arrangement, the limited partnership was to receive an annual net rental permitting a twelve per cent distribution to the investors.¹³⁵ For their reward, the promoters received a twenty per cent cost-free participation in The Concourse Plaza Company, as well as the amount, if any, by which the net operating income of the hotel exceeded the net rental payment to the partnership.¹³⁶ The Concourse Plaza syndication met with great favor on the part of the investing public, as did five other Nassau ventures, all but one utilizing the Concourse Plaza leaseback formula.¹³⁷ By 1957, the Nassau promoters had raised nearly five million dollars from twelve hundred subscribers.¹³⁸ In every instance, the only disclosures made to prospective investors were contained in crude brochures, which consisted mainly of sketchy property descriptions and overoptimistic profit-loss estimates.¹³⁹

For at least three of the ventures, operating realities did not coincide with the promoters' expectations.¹⁴⁰ Adverse competitive factors, unprovided-for capital improvement needs, and the burden of heavy debt-service depressed the properties while the promoters' ineptitude as hotel managers compounded their difficulties. In order to continue the promised rental payments, and thereby allay investor uneasiness, the promoters diverted subscription moneys from a proposed development project, commingled funds from various syndications, and failed to pay creditors.¹⁴¹ Instead of certified financial statements which would have exposed the impending ruin, the investors received misleading, but comforting, "status" reports.¹⁴² Eventually the Nassau empire crumbled, under the combined assault of tax and mortgage delinquency.

The Nassau debacle teaches the significance of full disclosure to prospective investors and regular certified accounts to syndicate participants. The inherent

133. *Id.*, Jan. 24, 1958, p. 25, col. 1; *id.*, Jan. 25, 1958, p. 40, col. 4.

134. Interview With Carl Madonik, Assistant Attorney General, New York State, in New York City, March 7, 1960.

135. N.Y. Times, Jan. 23, 1958, p. 1, col. 4, at 18, col. 4. A few favored investors received 15%-17% returns. *Id.*, Feb. 1, 1958, p. 7, col. 2.

136. Interview With Carl Madonik, *supra* note 134; see Hotel Concourse Plaza, Brochure [undated], p. 6.

137. N.Y. Times, Jan. 23, 1958, p. 1, col. 4, at 18, col. 4.

138. *Id.*, Jan. 23, 1958, p. 118, col. 4.

139. Interview With Carl Madonik, *supra* note 134. See also Hotel Concourse Plaza, Brochure [undated].

140. Interview With Carl Madonik, Assistant Attorney General, New York State, in New York City, Nov. 1958.

141. N.Y. Times, June 6, 1958, p. 1, col. 1.

Two officers of Nassau Management pleaded guilty to larceny charges arising out of their promoter activities. *Id.*, Dec. 17, 1959, p. 20, col. 5. They subsequently withdrew their guilty plea and have stated their willingness to face trial. *Id.*, Feb. 10, 1960, p. 32, col. 5.

142. See *id.*, March 16, 1958, § 1, p. 1, col. 5.

speculativeness of the proposed ventures and the promoters' inexperience in hotel management should have been revealed to the investing public. The glare of disclosure might have dampened public response, or at least manifested the potential risks. Perhaps, the promoters themselves would have taken a more considered view of their prospects, either abandoning the ventures or improving the management arrangements, had disclosure been forced. Furthermore, the burden of periodic certified statements might have deterred the commingling of funds, thereby preventing the germs of Concourse Plaza from infecting other ventures, as well as alerting the Nassau investors much sooner to their coming financial difficulties.

GOVERNMENTAL REGULATION OF REAL ESTATE SYNDICATION

Despite its desirability, full disclosure has not been readily available to the potential syndicate investor. Many solicitations do not supply information of sufficient scope and materiality upon which a sound investment choice may be predicated. Yet long-standing federal and state legislation affecting security offerings would seem to entitle the would-be syndicate participant to better information than he is now receiving.

The Securities Act of 1933

Federal regulation of newly issued securities received its major impetus with the enactment of the Securities Act of 1933.¹⁴³ This legislation is grounded in the philosophy of full disclosure—supply the prospective investor with the relevant facts and trust that these will guide him to a sound investment choice.¹⁴⁴ Under the act, the issuer files a registration statement with the Securities and Exchange Commission containing specified and detailed information about himself and the offering. The registration statement, and the accompanying documents, are reviewed by the SEC's Division of Corporate Finance for compliance with its standards of accurate and complete disclosure. Until the Commission's requirements are satisfied, and at least twenty days have elapsed after the original filing, the securities may not be lawfully sold.¹⁴⁵ In addition, an offering circular, its contents extracted from the registration

143. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1958).

144. See the President's Message, March 29, 1933, contained in H.R. REP. No. 85, 73d Cong., 1st Sess. 1 (1933). It reads in part:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

145. See 25 SEC ANN. REP. 28 (1958).

statement, must be furnished to the would-be purchaser for his examination before the security sale can become final.¹⁴⁶

In addition to providing the machinery for registration, the SEC also directs investigations to ferret out Securities Act violations, such as failure to register, the making of untrue statements, and the deliberate omitting of material facts.¹⁴⁷ Benign infractions, often based upon ignorance or misunderstanding, are customarily disposed of by consultation with the violator followed by his compliance.¹⁴⁸ For more serious offenses, the investigatory process may lead to administrative disciplinary proceedings, the seeking of injunctive relief in the federal courts, or referral to the Department of Justice for possible criminal prosecution.¹⁴⁹

146. See Securities Act of 1933, § 5(b) (2), 48 Stat. 77, as amended, 15 U.S.C. § 77e (b) (1958). See also Cohen, *Federal Legislation Affecting the Public Offering of Securities*, 28 GEO. WASH. L. REV. 119, 136, 137 & n.56 (1959).

During the 20 day "waiting" period, offers to sell, but not sales may be made, if within the bounds of § 10 of the act. See Cohen, *supra* at 132-37. See generally Lifton, *How To Organize a Successful Syndication*, The National Real Estate Investor, March 1960, p. 12 (syndicator's use of "red herring" prospectus during waiting period may depend upon size of promotion and his "confidence" in the deal).

147. Violations expose the issuer to both civil and criminal sanctions. *Civil*: Securities Act of 1933, § 12, 48 Stat. 84, as amended, 15 U.S.C. § 77i (1958), creates a cause of action in the security purchaser for recovery of the consideration paid less income, or for damages, against any person offering or selling securities in violation of Securities Act of 1933, § 5, 48 Stat. 77, as amended, 15 U.S.C. § 77e (1958), or by means of a misleading prospectus or oral communication if the mails or instruments of transportation or communication in interstate commerce are used. See *Jung v. K. & D. Mining Co.*, CCH FED. SEC. L. REP. ¶ 90887 (7th Cir. 1958) (action by investors to recover purchase price of securities). Securities Act of 1933, § 11, 48 Stat. 82, as amended, 15 U.S.C. § 77k (1958), creates a cause of action in the security purchaser for damages against persons who may have assisted in preparing the registration statement caused by untrue statements or material omissions in the registration statement.

Criminal: Securities Act of 1933, § 5, 48 Stat. 77, as amended, 15 U.S.C. § 77e (1958), makes unlawful the use of "any means or instruments of transportation or communication in interstate commerce or of the mails" for the offering or sale of securities unless registration statement, when required, is in effect for such security. Securities Act of 1933, § 17, 48 Stat. 84, as amended, 15 U.S.C. § 77q (1958), states a broad prohibition against the use of "interstate commerce" for the fraudulent offering or sale of any security. Securities Act of 1933, § 23, 48 Stat. 87, as amended, 15 U.S.C. § 77w (1958), forbids any person from misrepresenting that an SEC registration is equivalent to an SEC approval. Securities Act of 1933, § 24, 48 Stat. 87, as amended, 15 U.S.C. § 77x (1958), denominates the maximum penalties for a criminal violation of the Securities Act—\$5,000 fine or 5 years imprisonment or both.

148. 24 SEC ANN. REP. 176 (1958).

Paul Windels, Jr., SEC Regional Administrator furnished this example: A syndicated property had, for its sole occupant a lessee whose lease would expire less than a year after the offering. In preparing his brochure, the promoter must have overlooked the shortness of the remaining rental term; at least, the brochure did not mention it. The promoter, after an SEC arranged conference, agreed to revise his offering circular. Many sales, however, had already taken place. Interview With Paul Windels, Jr., in New York City, Nov. 8, 1958.

149. *Ibid.*

For the prospective investor, the apparatus of enforcement is meaningful if it ensures compliance with the statute and gives full and honest disclosure *before* his investment funds are committed. Thus, an injunctive decree prohibiting further sales will not aid in salvaging any part of the principal already invested in a leaky venture. Moreover, most real estate participation units are presently being sold without any attempt being made by offerors to comply with the disclosure process contemplated by the Securities Act. For example, of the 201 limited-partnership real-estate syndicates evidenced by certificates filed during 1958 and 1959 in the New York County Clerk's Office, only 8 followed the SEC channels.¹⁵⁰

A combination of factors seems to have contributed to this noncompliance. Included among these are uncertainty as to whether various forms of syndicate interests are "securities" as defined by the act; the availability, real and illusory, of statutory exemptions; the apparent aversion of most syndicate promoters to registration; and the SEC's failure to interject itself more positively into syndication by accommodating its registration process or its enforcement powers to the unique problems of syndication.

The availability to the syndicate investor of SEC protection hinges preliminarily upon a matter of definition. Does a participation unit in a real estate syndicate constitute a "security"? Section 2(1) of the Securities Act defines security as:

... any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, or, in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.¹⁵¹

150. The syndicates in this sampling that completed an SEC registration, based on records in the Washington office of the SEC were:

| Name of Syndicate | SEC File No. |
|----------------------------|--------------|
| Astor Associates | 13988 |
| Futterman-DuPont Hotel Co. | 15148 |
| The Teagen Company | 15239 |
| Dexter Horton Realty Co. | 15241 |
| Drake Associates | 15490 |
| Texmar Realty Company | 15541 |
| National Munsey Co. | 15663 |
| Montmartre Hotel Co. | 15987 |

Not one of the approximately 100 syndicate offerings seeking \$300,000 or less ("small issue") made a Regulation A filing, see notes 168-69 *infra* and accompanying text, according to records in the New York Regional Office of the SEC.

151. Securities Act of 1933, § 2(1), 48 Stat. 74, as amended, 15 U.S.C. § 77b(1) (1958).

Because no explicit reference is made either to "syndicate" or to the usual forms in which syndicate interests are marketed,¹⁵² some syndicate promoters have been willing to infer that they are beyond the pale of the act.¹⁵³ It is doubtful, however, whether their inferences will withstand the combined weight of legislative intent, judicial construction, and current SEC sentiment.

In formulating the section 2(1) definition, Congress gave abundant evidence of its desire to include all the forms of public security offerings, known and unknown.¹⁵⁴ In 1933, public participation in real estate had already taken the form of "stock," "debentures," "evidence of indebtedness," "certificate of interest in profit-sharing agreements," and "collateral trust certificates." With respect to each of these, section 2(1) is explicit.¹⁵⁵ But the modern forms of syndicate enterprise—the public sale of limited and general partnership units and direct ownership (exclusive of oil, gas, or mineral rights) interests in real property were unknown a generation ago. Otherwise, it is likely, in view of the announced broad purpose in the legislative history, that Congress would have expressly included them.

The judiciary has given generous content to the language of section 2(1).¹⁵⁶ Twice the United States Supreme Court has found an equivalency between "security" and the public sale of direct interests in real estate. In *SEC v. C. M.*

152. Despite the absence of "limited partnership" within the § 2(1) definition of security, theatrical producers have traditionally filed or registered under the Securities Act when raising money via sales of limited partnership interests. Interview With Paul Windels, Jr., SEC Regional Administrator, in New York City, Nov. 7, 1958; see, e.g., Regulation A filings for The Andersonville Co., No. 24 N.Y.-4911, Sept. 1, 1959; Miracle Worker Co., No. 24 N.Y.-4905, Aug. 3, 1959; Fiorello Co., No. 24 N.Y.-4848, May 25, 1959, in the New York office of the SEC. The high risk factor of a Broadway play may prompt theatrical producers to immunize themselves against the likelihood of a disenchanted angel seeking his money back—a remedy furnished by § 12 of the Securities Act to an investor if the issuer fails to comply, without justification, with the registration provisions of § 5. See note 147 *supra*.

153. *N.Y. Hearings on Real Estate Syndication Before Hon. George Frankenthaler*, Nov. 18, 1957, p. 24a, on file in the New York City office of the New York State attorney general.

154. "[T]he term 'security' . . . [is defined] in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933).

155. As further evidence that public real estate offerings were within Congress' contemplation, the original statute also made reference to "certificate of interest in property, tangible or intangible." Sec. 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(1) (1958). In the 1934 amendment to § 2(1), 48 Stat. 905 (1934), the term "security" was expanded to include "certificate of deposit for a security," "fractional undivided interest in oil, gas, or other mineral rights," and "any interest . . . commonly known as a 'security.'" Simultaneously, the original category "certificate of interest in property, tangible or intangible" was deleted.

156. See, e.g., *SEC v. Starmont*, 31 F. Supp. 264, 267 (E.D. Wash. 1940) (Securities Act of 1933 a "remedial enactment"; security "to be liberally construed").

Joiner Leasing Corp.,¹⁵⁷ defendant, after acquiring a lease upon 4,700 acres of potentially oil-bearing land, sought to raise development funds by public subscription. The investors received partial assignments of the dominant leasehold in parcels ranging from two and one-half to twenty acres. In addition, Joiner contracted with each investor to conduct oil explorations upon the dominant leasehold parcel.

The SEC sought to restrain the defendants from further sales in violation of both the registration and antifraud provisions of the Securities Act. In finding for the Commission, the Supreme Court rejected the defendant's argument that leasehold interests were "mere" interests in real estate and not section 2(1) securities. The crucial fact for the Court was that the defendants were selling more than "naked leasehold rights"; they were also trading in the economic inducements of the proposed exploration well. This package arrangement, the Court held, was within the section 2(1) concept of "investment contract." In committing itself to a liberal construction of section 2 the Supreme Court declared:

[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices . . . are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealings which established their character in commerce as "investment contracts," or "as any interest or instrument commonly known as a 'security.'"¹⁵⁸

In *SEC v. W. J. Howey Co.*,¹⁵⁹ the Court gave further content to the meaning of an "investment contract." Defendant owned large tracts of Florida citrus acreage. It publicly offered for sale strips of land transferable via warranty deed. In addition, at extra cost, service contracts were available by which the defendant agreed to cultivate the acreage and pay the net profits to the owner. Most, but not all, purchasers acquired the service contracts.

The Court agreed with the SEC that the defendant should have registered the offering, characterizing it as the sale of investment contracts. That the service contracts were optional, which might have distinguished these facts from the *Joiner* arrangements, received only passing notice. An investment contract, according to *Howey*, is a "scheme, whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party." The form of the investment unit, whether certificates or warranty deeds, is immaterial.

State and lower federal courts have consistently followed this rationale.¹⁶⁰

157. 320 U.S. 344 (1943).

158. *Id.* at 351.

159. 328 U.S. 293 (1946).

160. See *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959); *Jung v. K. & D. Mining Co.*, CCH FED. SEC. L. REP. ¶ 90887 (7th Cir. 1958). For a collection of "investment contract" decisions, see LOSS, SECURITIES REGULATIONS 318-20 & nn.37-49 (1951, Supp. 1955, at 150-51).

A wonderland of promotional schemes have been deemed investment contracts, subject to federal or state securities control. But not until the 1956 Illinois decision in *Sire Plan Portfolios, Inc. v. Carpentier*¹⁶¹ had a determination involved syndication. Although the decision's direct impact is limited to the Illinois Blue Sky Act,¹⁶² federal courts have not hesitated to employ state rulings where, as here, the relevant language of the state statute and the Securities Act are virtually identical.¹⁶³

Under the SIRE Plan syndication, each investor became a cotenant of the real property, evidenced by a warranty deed describing an undivided fractional interest. The investors then leased back the property, an apartment house, to the promoter's wholly-owned affiliate, which undertook the management and the payment of quarterly rental distributions. Citing *Howey*, the court ruled that SIRE Plan units were "investment contracts" within the ambit of the state's Blue Sky regulation. The opinion stressed the investors' complete dependence upon the promoter's managerial efforts for their rewards, if any, and the resulting lack of control over the enterprise's expectancies. The SIRE Planners, as the orange tree vendees in *Howey*, had made an "investment" in real property having as an intrinsic feature, and without which the investment might not have been made, a "contract" for the property's management and development.

In evolving the concept of an investment contract as a security, therefore, the courts have emphasized the investors' dependence upon the promoter or a third party for profit. The SEC has welcomed this interpretation, and has embellished it by formulating a pattern of practices tending to demonstrate promoter, rather than investor, control over an enterprise.¹⁶⁴ These include sole investigation and selection of the property by the promoter; implied or actual guarantee of specified yield; the sale of fractional interests; and circumstances necessitating complete reliance upon the promoter, such as distance between property and investor; and the servicing of the property. In summary, the Commission has declared:

The wider the range of services offered and the more the investor must rely on the promoter or third party, the clearer it becomes that there is an investment contract. While there may be circumstances under which

161. 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956).

162. ILL. REV. STAT. ch. 121½, § 137.2(A) (1957).

163. See, e.g., SEC v. W. J. Howey Co., 328 U.S. 293, 298 (1946), where the Supreme Court relied on state "Blue Sky" decisions to determine the meaning of "investment contract" in the Securities Act.

The Florida attorney general expressed his opinion that the solicitation of limited partners met the "securities" test of his state's Blue Sky Law. Although the wording of the Florida statute was slightly distinguishable from its Securities Act counterpart, the attorney general considered the "investment contract" language of the *Howey* case a sufficient analogy. 2 BLUE SKY L. REP. ¶ 70388.

164. See SEC Sec. Act Release No. 3892, Jan. 31, 1958. Although the SEC's opinion quoted therein is directed to the sale of fractional interests in mortgages or deeds of trusts,

one or more of these elements are present without constituting an investment contract, it is the position of the Commission that each of them has a bearing on whether the investor is relying "solely on the efforts of the promoter or third party" to use the investor's money and through these efforts to return a profit to the investor—the essential test of an investment contract.¹⁶⁵

Whatever "investment contract" may have meant to the 73d Congress, judicial and administrative constructions have made the term capable of encompassing nearly all syndicate offerings,¹⁶⁶ since promoter control and investor dependency are distinctive features of the real estate syndicate, regardless of its organizational format.

Even though a syndicate offering is a security under section 2(1), an issuer may be exempted from registration by other provisions of the act. In an effort to reduce the workload of the SEC, Congress exempted from registration various securities and transactions which involved minimal risks to the prospective investor or which could be readily policed at the state or local level.¹⁶⁷ For example, the Commission was authorized to exempt from its registration procedure "small" issues, presently defined as any issue of securities in the principal amount of 300,000 dollars or less which is marketed in one calendar year.¹⁶⁸ The "small" issue, however, does not entirely escape the preoffer scrutiny of the SEC, for it is subject to the filing requirements of Regulation A, a stripped-down version of a full registration.¹⁶⁹ Two exemp-

the "investment contract" criteria set forth in the opinion seem useful in determining whether a participation unit in a real estate syndicate will be deemed a § 2(1) security.

165. SEC Sec. Act Release No. 3892, Jan. 31, 1958, reprinted in CCH FED. SEC. L. REP. ¶ 76559.

166. "Whether they [real estate syndicates] take the form of a Massachusetts or other type of trust, a limited or general partnership, a joint venture, a fractionalized title or mortgage, or anything else that the ingenuity of the lawyer or the promoter may devise, it is required by the Securities Act of 1933 that the interests which are sold or even offered for the purpose of raising money be registered." Remarks of Paul Windels, Jr., SEC Regional Administrator, to the Association of Real Estate Syndicators, Inc., Feb. 6, 1958, New York City.

For judicial construction, see notes 156-64 *supra* and accompanying text.

167. Securities Act of 1933, §§ 3a, 4, 48 Stat. 75, 77, as amended, 15 U.S.C. §§ 77c, 77d (1958).

168. 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77c(b) (1958); see 17 C.F.R. §§ 230.251-262 (Supp. 1959).

A syndicator may promote any number of real estate ventures within a year without losing the small issues exemption for each issue not exceeding \$300,000. See 17 C.F.R. § 230.254(d) (5) (Supp. 1959).

169. Under Regulation A procedure, the issuer files on form 1-A with an SEC Regional Office for the region in which the issuer's principal business operations are conducted at least ten days prior to the date of issue. 17 C.F.R. § 230.255 (Supp. 1959); SEC Sec. Act Release No. 3663, July 23, 1956. *Query*: If the syndicated property is located in Region A, and owned by a limited partnership organized in Region B, where should the filing take place? If the offering exceeds \$50,000 each investor must be given prior to purchase an

tions which make registration in any form unnecessary provide the basis upon which syndicate promoters have regularly avoided full disclosure under the act—section 3(a)(11) exempting “intrastate” transactions and section 4(1) exempting private offerings.

To qualify as an exempt intrastate offering, the issue must be offered *and* sold only to residents of the same state or territory in which the issuer is resident *and* doing business.¹⁷⁰ Offers or sales to nonresidents extinguish the exemption retroactively to the date when the issue was first offered publicly.¹⁷¹ A solicitation by the mails, newspapers, or other interstate media, however, will not cause the loss of 3(a)(11) immunity in the absence of other factors,¹⁷²

offering circular containing the information shown at schedule I of form 1-A. 17 C.F.R. §§ 230.256-.257 (Supp. 1959).

Form 1-A appears in 1 CCH FED. SEC. L. REP. ¶¶ 7325-27. For a comparison with form S-1, the registration statement used by a nonexempt real estate syndicate in a Securities Act § 5 registration, see 1 CCH FED. SEC. L. REP. ¶¶ 7121-29. For a further discussion of form S-1, see text at notes 206-10 *infra*.

For discussions of Regulation A, see generally Glavin & Purcell, *Securities Offerings and Regulation A—Requirements and Risks*, 13 BUS. LAW. 303 (1958); LOSS, *SECURITIES REGULATION* 380-87 (1951); Cohen, *Federal Legislation Affecting the Public Offering of Securities*, 28 GEO. WASH. L. REV. 119, 148 n.72 (1959).

170. 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77c(a) (1958):

Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

....

(11) Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

For a discussion of § 3(a)(11), see McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959).

171. SEC Sec. Act Release No. 1459, May 29, 1937, reprinted in 1 CCH FED. SEC. L. REP. ¶ 2245.25; Petersen Engine Co., 2 S.E.C. 893, 903 (1937) (sale by New York corporation to one New Jersey resident violated § 3(a)(11) exemption).

In 1954, § 3(a)(11) was amended to subject offers, as well as sales, to the single-state requirement. See S. REP. No. 1036, 83d Cong., 2d Sess. 13 (1954).

The Commissioner construes residence to mean domicile in the conflicts-of-law sense. LOSS, *SECURITIES REGULATION* 379 n.252 (1951); see S. REP. No. 1036, 83d Cong., 2d Sess. 13 (1954).

172. SEC Sec. Act Release No. 1459, May 29, 1937, reprinted in 1 CCH FED. SEC. L. REP. ¶ 2245.25:

... [T]he so-called “intrastate exemption” is not in any way dependent upon absence of use of the mails or instruments of transportation or communication in interstate commerce in the distribution . . . Securities thus exempt may without registration be offered and sold through the mails, may be made the subject of general newspaper advertisement (provided the advertisement is appropriately limited to indicate that offers to purchase are solicited only from, and sales will be made only to, residents of the particular state involved), and may even be delivered in interstate commerce to the purchasers, if such purchasers, though resident, are temporarily out

provided that the appeal is addressed exclusively to residents of the issuing state.

The intrastate exemption has been highly useful to real estate syndicators. Quite commonly, promoters have been able to solicit and raise all of the funds needed, often amounting to several hundred thousand dollars, within the boundaries of a single jurisdiction. More than sixty per cent of the certificates of limited partnership filed during 1958 by real estate syndicators in the New York County Clerk's Office were executed entirely by professed New York State residents; the largest offering exceeded two million dollars.¹⁷³ By design, the nonresident investor is assiduously shunned, and assuming that section 3 (a) (11) is not otherwise overstepped, the promoter avoids federal registration. To the extent that state control of the intrastate transaction effectively replaces federal nonsurveillance, the interests of an investor may yet be protected. But the range and vitality of state Blue Sky activities vary widely. Among the state statutes, one of the skimpiest in terms of protection afforded to the investor has been New York's Martin Act, which presently lacks any disclosure requirement other than identification of the issuer.¹⁷⁴ This is particularly unsettling in view of New York's status as the center of syndicate activity. Thus, the coalescing of section 3(a)(11) and a weak Blue Sky Law has entirely deprived significant numbers of syndicate investors of the benefits of disclosure.

of the state or should direct delivery to some non-resident agent or custodian. . . . Exemption . . . , if . . . available, removes the securities from the operation of all provisions of the Act except those of Sections 12(2) [civil liability for sale of security by use of any interstate means or instruments and making untrue statement of material fact or omitting a material fact], 17 [employing instruments of interstate commerce for fraudulent transactions].

173. Every signer in 35 of 55 limited partnership certificates filed in the New York County Clerk's Office during 1958 used a New York state address. Of these, Newark Center Bldg. Co., filed May 23, 1958, had the largest capitalization; 307 limited partners invested \$2,300,000 to acquire a leasehold in Newark, New Jersey.

| Syndicate Investment (Dollars) | No. of Ventures | No. of Ventures—New York State Addresses Only |
|-----------------------------------|-----------------|--|
| \$50,000 or less | 4 | 3 |
| \$50,001-\$100,000 | 11 | 5 |
| \$100,001-\$300,000 | 16 | 8 |
| \$300,001-\$500,000 | 8 | 5 |
| \$500,001-\$1,000,000 | 7 | 7 |
| \$1,000,001-\$2,000,000 | 7 | 6 |
| over \$2,000,000 | 2 | 1 |

Four of the ventures included in the table set forth in the text at 733 *supra* did not list their investors in the original limited partnership certificates.

See also, for example, seven block ads inviting syndicate investment. N.Y. Times, Sept. 20, 1959, § 8, p. 6, col. 4; *id.* at 9, col. 3; *id.* at 11, col. 1; *id.* at 15, cols. 5, 6-7, 8; *id.* § 3, p. 6, col. 1 (five are addressed to New York State residents only).

174. N.Y. GEN. BUS. LAW §§ 352-59; see text at notes 218-24, 235 *infra*.

Promoter reliance upon section 3(a)(11) as a basis for exemption may, however, be misplaced. For example, the recital in a limited partnership certificate that the issuers and subscribers all reside in one state would not suffice to sustain the intrastate exemption were it shown that a syndicate interest had been offered for sale to a nonresident; that the subscriber of record is acting in a nonresident's behalf;¹⁷⁵ or that the recital of residence is factually unsupportable.¹⁷⁶ Promoters seeking to insulate themselves from federal registration via section 3(a)(11) customarily obtain an affidavit of residence and nonagency from the prospective subscriber;¹⁷⁷ whether this will preserve the exemption in the event of a subscriber's deliberate misstatement is not altogether clear.¹⁷⁸ Furthermore, some promoters seem unaware that the requirement of one hundred per cent nondiversity is literally construed by the Com-

175. See *SEC v. Hillsborough Investment Corp.*, 173 F. Supp. 86, 88 (D.N.H. 1958) (for intrastate exemption to be available, securities must be in hands of resident investors upon completion of ultimate distribution); SEC Litigation Release No. 1549, Dec. 18, 1959 (issuers indicted and convicted for failure to register; dummies and nominees used to create appearance of intrastate transaction).

176. The use of a temporary address would not make the person a resident. THOMAS, *FEDERAL SECURITIES ACT HANDBOOK* 23, 28 n.1 (1959).

177. Subscribers to Thirty-Four Associates signed an affidavit containing the following:

1. This affidavit is being made by deponent for the purpose of inducing Thirty-Four Associates, a New York Limited Partnership, having its principal office at 521 Fifth Avenue, New York, New York, to permit my subscription for, and purchase of, an interest therein as a Limited Partner.

2. I am an adult resident of, and domiciled in, the State of New York. I am subscribing for and purchasing the aforesaid interest in Thirty-Four Associates on my own behalf and for my own beneficial interest, and not as the agent for or representative of any other person, and without any intention to resell, assign, or otherwise transfer such interest to any person who is not a resident of and domiciled in the State of New York.

Affidavit on file in Yale Law Library.

For a further safeguard against a resident investor buying *in order* to resell to a nonresident, see 501 Fifth Realty Co., Copartnership Notice, N.Y.L.J., Nov. 12, 1959, p. 17, col. 7 ("for one year . . . no Limited Partnership unit assignable without written consent of any one of the General Partners").

178. Although the absence of wilfulness would bar the criminal penalties of § 24, see *LOSS, SECURITIES REGULATION* 1109 (1951), it is uncertain whether the issuer would also avoid the civil sanctions of §§ 12(1) and 20(b) (SEC given power to enjoin Securities Act violations). Professor Loss does not believe that Congress expected the issuer to insure each investor's residence, provided he makes due inquiry. *Id.* at 379 n.252. A second commentator, however, is less sanguine. He advises an issuer relying on § 3(a)(11) to secure some collateral evidence—*e.g.*, a voter's certificate of registration, in addition to the offeree's self-serving statement. THOMAS, *FEDERAL SECURITIES ACT HANDBOOK* 23 (1959). *Query*: Although he might use this technique before completing a sale, how can a promoter, in advance of his offer to sell, feasibly seek such assurance from every offeree? A court might find a way around this barrier by imposing a higher level of inquiry after the offer and before the sale.

mission. With surprising frequency, the public records disclose syndications containing a sprinkling of nonresident participants where it was probable, from the fact of nonregistration, that a section 3(a)(11) exemption was contemplated.¹⁷⁹ No basis exists for an expectation that a slight deviation, made with knowledge, from the single residence requirement will be overlooked as *de minimis*.

When issuer and investors reside in one state, but the real property upon which the enterprise feeds is located elsewhere, the 3(a)(11) exemption may be unavailable. Section 3(a)(11) requires that the issuer reside *and* conduct business within a single state. The limits of "doing business" in this phrase are muddled.¹⁸⁰ Syndicators maintain that the location of the entity's home office, particularly if the financial and business records are kept therein, meets the "doing business" test.¹⁸¹ On the other hand, an SEC representative has announced informally that the Commission will equate "doing business" in the syndication sense with the operation of the real property, and that the situs of the real property is the controlling factor.¹⁸²

179. Of the twenty ventures having diversity of investor residence, see note 173 *supra*, the promoters in eleven may have contemplated a § 4(1) private offering exemption. 48 Stat. 77, as amended, 15 U.S.C. § 77d(1) (1958); see text at notes 259-68 *infra*. In each of the other nine, where the investor count makes it likely that the exemption-seeking promoter did not contemplate a private offering the number of non-New Yorkers did not exceed six; four of the ventures had only one nonresident.

180. One writer, without citing his authority, has stated that the SEC's view "over the years is that the issuer must conduct its principal business within the state [of issue]." McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937, 950 (1959). The SEC has not formalized this view, although Commission officials have recently paid it lipservice, see note 257 *infra*, and *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Cal. 1957), discussed in note 181 *infra*, suggests a more forthright approach.

181. For the view that the "doing business" test is not one of limitation, see Loss, *SECURITIES REGULATION* (Supp. 1955, at 163 n.252):

So far as concerns the requirement that the issuer also be "doing business" within the state, it is understood to be the administrative construction that the issuer's business need not be *confined* to the one state . . . that even the main part of the issuer's business may be conducted in another state; but that the issuer must be doing some business in the state of the offering other than selling the securities in question.

In 1957, the SEC sought an injunction against Truckee Showboat, Inc., a California corporation, to prevent the sale of non-registered corporate securities to California residents. The proceeds were earmarked for the purchase and operation of the El Cortez Hotel in Las Vegas, Nevada. The defendant claimed relief from registration upon the "intrastate exemption" of § 3(a)(11). The court ruled that the planned ownership and operation of the Nevada hotel destroyed the "intrastate exemption." During the litigation, however, the defendant withdrew its offering and the motion for injunction was denied since the issue had become moot. *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Cal. 1957).

182. Remarks of Paul Windels, Jr., SEC Regional Administrator, to Realty Investment Syndicators Ass'n, New York City, Feb. 6, 1958. Mr. Windels intimates that even if the property is located where the issuer and investors reside, the 3(a)(11) exemption may

The intrastate exemption should be available, if at all, only when the entire enterprise, from the initial securities offering through the venture's operation, can be supervised by the officialdom of a single state. Otherwise, the dilution of control among the authorities of two or more states, with its attendant delays, customary differences, and jurisdictional barriers may water down the effectiveness with which the investor's interests are protected. The desired objective of unitary control, assuming that the controlling state has an adequate program for investor protection, is unattainable for the regulation of a syndicate emanating from state *A* based upon real estate situate in state *B*. Proceedings affecting the property, such as an action to enjoin its disposition or the appointment of a receiver, would necessarily originate in state *B*, whereas in personam proceedings directed to the promoter's activities, such as failure to register the syndicate offering, misrepresentation, or breach of managerial agreement, would ordinarily be instituted in state *A*. Any attempt by the Blue Sky officials of state *A* to investigate or restrain the property's operation would, in most instances, require the active cooperation of state *B* personnel. Even the initial process of registration, when it is predicated upon full and honest disclosure, would become more fruitful if the officials of state *A* were able to view, or had some familiarity with, the property and its surroundings. In contrast, the SEC, with its nationwide network of offices and ready access to the facilities of a United States Attorney and the federal judiciary, is equipped to transcend state lines. Thus it would seem that investor protection is more effectively maximized by denying the section 3(a)(11) exemption unless the syndicate participants and the real property are located within a single state.

A Securities Act filing or registration may be avoided by bringing the transaction within section 4(1), which exempts "transactions by an issuer not involving any public offering."¹⁸³ The statute does not define "public offering," nor does it establish a quantitative test in terms of the number of offerees in the fashion of many state Blue Sky Laws.¹⁸⁴ In 1934, the SEC General Counsel ventured that "under ordinary circumstances an offering to not more than approximately twenty-five persons . . . presumably does not involve a public offering."¹⁸⁵ Despite his further qualification that the number of offerees was

be lost if the building is leased to an out-of-state concern. It is difficult to detect any reading of the statute that would support this view.

183. Securities Act of 1933, § 4(1), 48 Stat. 77, as amended, 15 U.S.C. § 77d(1) (1958). See generally *Israels, Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851 (1959); *Victor & Bedrick, Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869 (1959); *Loss, SECURITIES REGULATION 394-403* (1951); *Williams, Exempted Transactions under Section 4(1)*, 15 BUS. LAW. 138 (1959); *Cohen, Federal Legislation Affecting the Public Offering of Securities*, 28 GEO. WASH. L. REV. 119, 141-44 n.64 (1959).

184. For a discussion of the private offering counterpart of state Blue Sky statutes, see *Loss & Cowett, BLUE SKY LAW 368-74* (1958) [hereinafter cited as *Loss & Cowett*].

185. SEC Sec. Act Release No. 285, Jan. 24, 1935, reprinted in *SEC, COMPILATION OF RELEASES UNDER SECURITIES ACT OF 1933*, at 87 (1936).

not an exclusive determinant, and the SEC's refusal to issue an administrative ruling, the exempt status of an offering to twenty-five persons or less has become a convenient, if not entirely dependable, rule of thumb.¹⁸⁶

Because this quantitative "test" stresses the number of offerees, rather than ultimate investors, its utility is limited. The Commission has evidentiary difficulties in establishing that an offer to sell, in contrast with an actual sale, has been made, while the syndicator's activities may be unduly hampered, since twenty-five offers may result in only a handful of sales. Accordingly, syndicate managers have preferred to view the rule of twenty-five not as a ceiling upon the availability of the private-offering exemption, but as a crossover point at which various other factors become relevant. In *SEC v. Ralston Purina Co.*,¹⁸⁷ the Supreme Court attempted to summarize these other factors by focusing its inquiry upon "the need of the offerees (whether few or many) for the protection afforded by registration."¹⁸⁸ If a need for protection exists, the offering is public. Whether a need exists would depend upon both the expertise of the offerees and their alternative means of access to the information which registration would disclose. Lower federal courts, in concluding that in the absence of such need an offering was private, have emphasized the previous business relationship between the parties and the "sophisticated discernment" with which the purchasers entered into the transaction.¹⁸⁹

In its application to the real estate syndicate, section 4(1) should be handled gingerly. The venture characterized by an open and indiscriminate appeal for investor funds is clearly a public offering,¹⁹⁰ regardless of the ultimate number of participants. Less heralded, however, are the bulk of syndications, where the methods of solicitation manifest many traits common to private offerings. These include the extensive use of person-to-person solicitation, the absence of an underwriting agreement, the disdain of mass advertising media. Occasionally, the promoter conducts no formal solicitation; word-of-mouth rumors that the syndication is being organized may result in its oversubscription. Nevertheless, since the Securities Act is founded upon investor need, the benefit to the promoter of section 4(1) should not inure automatically because of his promotional methods. Instead, the focus must remain upon the identity and the information sources of the offeree.

186. See Kroll, *The Why and How of Real Estate Syndications: Regulation Aspects*, *Prac. Law.*, March 1959, p. 70, at 73.

187. 346 U.S. 119 (1953).

188. *Id.* at 127.

189. See *Woodward v. Wright*, 266 F.2d 108, 115 (10th Cir. 1959) ("closely knit arrangement among friends and acquaintances . . . All of the purchasers apparently entered into the transaction with sophisticated discernment"); *Campbell v. Degenther*, 97 F. Supp. 975 (W.D. Pa. 1951) (sale of securities to 32 persons known to issuer "through mutual business associates" held a private sale).

190. See block ad in *N.Y. Times*, Sept. 20, 1959, § 8, p. 14, cols. 6-7; *N.Y. Times*, June 29, 1958, § 10 (reprint of *Motors Building Realty Co.*, Prospectus, June 3, 1958).

In determining the availability of section 4(1) shelter the desirability of further straining the Commission's facilities¹⁹¹ in order to regulate syndicates of relatively few investors must be explored. Any argument addressed to the practical difficulties of regulation ordinarily deserves a respectful audience, but its advocacy must reflect a balancing of the marginal cost of added enforcement energy against the risks of nonenforcement. The nation's stake in the integrity of the syndication process cannot be measured solely by the actual number of investors in any single transaction. One of the tenets of a solvent economy is that its real estate wealth be operated and financed upon a sound and honest footing, sustained by a high level of public confidence. History shows that the isolated failure of a well-known real estate venture may have a depressing effect on the national economy. Because syndication is increasingly affecting the acquisition and development of the nation's real estate resources, and particularly major commercial and multifamily residential parcels, strong justification exists for public scrutiny of its operation. Weighing the premium for increased regulation of the syndicate offering against social desirability restores the practical, as well as the conceptual, balance in favor of section 4(1) limitation.

The prophylactic intent of the Securities Act is further diluted by infirmities in its administration. To the extent that its regulations are unenforced, or are applied by unskilled personnel, or are not relevant to the unique problems of real estate offerings, the investor's reliance upon the administrative process to guarantee full disclosure is misplaced. Similarly, compliance with the regulations may unduly burden the syndication process so as to encourage non-compliance by the promoter or dampen his entrepreneurial initiative.

To date, the syndicate promoter has tended to resolve the ambiguities of the Securities Act against compliance with its disclosure requirements. Foremost among the factors affecting his decision is the practical difficulty of resolving the business demand for rapid action with the inherent delays of the compliance process. Registration takes time; and in the context of real estate transactions, time of performance is often crucial. The preliminary negotiations for the transfer of real property interests may hinge upon the parties' agreement as to a closing date; and after the contract is negotiated, the vendee ordinarily must perform within a relatively short period.¹⁹² Furthermore, a

191. See 25 SEC ANN. REP. 1, 4 (1959).

192. Interview With Louis J. Glickman, New York Syndicator, in New York City, Nov. 27, 1959; Interview With Albert Mintzer, Founder, The SIRE Plan, Inc., in New York City, Oct. 25, 1958.

Syndicators sometimes bargain for a lengthy performance period. See Madison-54th Realty Co., Offering Circular [undated], p. 1 (100 days); The Teagen Co., Prospectus, Aug. 24, 1959, p. 8 (7 months, 28 days). And the seller may agree prospectively to postpone the closing date if the vendee makes an additional cash deposit for each extension. See Garment Capitol Associates, Prospectus, Feb. 13, 1957, p. 7 (additional \$250,000 deposit for each of two one-month adjournments).

Time is less pressing if the promoter already owns or has an interest in the property

purchaser usually forfeits a substantial deposit for failure to perform¹⁹³ on the closing date. If he expects to syndicate the venture, and is dependent upon investors' funds to fulfill his contractual obligations, the speed with which the offering can be launched is crucial. By contrast, the decision of an industrial concern to launch a securities issue is seldom subservient to the same demands of time.

When viewed against the urgency of the syndicate promoter's needs, the registration process consumes too much time. In the year ending June 30, 1959, the median Securities Act registration of all issues required twenty-eight days from the date of filing.¹⁹⁴ But often syndicate promoters may not fare even this well.¹⁹⁵ The prolonged handling of syndicate offerings results from the unfamiliarity of many promoters, or their attorneys, with SEC procedure, the Commission's own inexperience with syndicate venture¹⁹⁶ and its failure to change gears presently adjusted for industrial offerings.¹⁹⁷ To the time spent before the SEC, however, must be added the preliminary period during which the promoter prepares his first submission. The promoter or his experts must abstract financial records, gather the opinions of tax¹⁹⁸ and legal coun-

that he plans to syndicate. See, e.g., Stanbalt Realty Co., Brochure, Dec. 16, 1957, pp. 5-6; Hotel Taft Associates, Prospectus, Jan. 2, 1958, pp. 6, 8.

193. See note 6 *supra* and accompanying text.

194. 25 SEC ANN. REP. 28 (1959). In the 1958 and 1957 fiscal years, the medians were 24 days and 23 days respectively. *Ibid.*

195. Statement of Marvin Kratter to Students of Yale Law School, Jan. 13, 1960; Interview With Edward M. Cowett, in New York City, Feb. 12, 1960.

An examination of the SEC files made by the author revealed that the median span for seven of the eight syndications listed in note 150 *supra* to complete their registrations from initial filing to effective date, was 50 days.

196. SEC records reveal that in the two years ending June 30, 1959, only 18 real estate syndicates filed registration statements. During this interval, there were 2139 filings. See 25 SEC ANN. REP. 29 (1959); 24 SEC ANN. REP. 33 (1958). In its 1959 *Report*, the Commission attributed the increased median interval between filing and effective date to "the substantial increase in the number of registration statements filed," a large number of which related to new or unseasoned ventures which required relatively more time and effort in making an appropriate review." 25 SEC ANN. REP. 28 (1959).

197. See text at notes 206-09 *infra*.

198. Tax opinions generally accompany a registration of an unincorporated association and are then extracted in the prospectus. The following is a typical prospectus digest:

2. *Tax Status of Associates and the Joint Ventures.* Stevenson, Paul, Rifkind, Wharton & Garrison, 1614 Eye Street, N.W., Washington, D.C., tax counsel, has furnished Associates with an opinion that the members of Associates and of the joint ventures to be formed under the Participating Agreements will qualify as partners for Federal income tax purposes. Therefore, the individual members of Associates and each participant will be taxed on his distributive share of the net income, but the net incomes of Associates and the joint ventures will not be taxable as such.

Such opinion notes that the Treasury Regulations contain provisions under which partnerships or joint ventures may be taxed on their net income in the same manner as corporations and the members thereof may be taxed as shareholders. The opinion,

sel, draft the organization instruments, and prepare the registration statement and prospectus.¹⁹⁹ Thus, compliance with SEC registration requirements may consume two to three months.²⁰⁰ Unless compliance time is measurably reduced, promoters confronted with short-term deadlines for contract performance will persist in Securities Act avoidance. While a more energetic program of enforcement by the Commission could force compliance, such action would doubtless have the added result of reducing real estate syndications.

The registration statement²⁰¹ is the crucial document in the registration process. Its contents form the basis for the Commission's review and, when incorporated in the prospectus,²⁰² the grist for the prospective investor's analysis. The Securities Act provides, generally, for the information and documents that the registration statement for domestic corporations shall contain.²⁰³

In a number of instances, forms have been tailored to suit the needs of specialty issuers.²⁰⁴ For example, exploratory mining corporations, oil or gas interests, developmental companies receive particularized treatment.²⁰⁵

Form S-1 is the ready-made registration instrument for most commercial and industrial offerings²⁰⁶ and, because the SEC has not yet sought to distinguish it, the real estate syndicate registers with this form. An analysis of Form S-1²⁰⁷ suggests that its coverage includes much that has only peripheral importance to the real estate syndicate,²⁰⁸ and at the same time, omits, or

however, concludes that Associates and the joint ventures involved herein do not fall within the said provisions, and therefore should not be taxable as corporations.

Dyckman Hotel Associates, Prospectus, Jan. 27, 1959, p. 8.

199. See text at note 201 *infra*.

200. Interview With J. M. Tenney, in New York City, Nov. 27, 1959; Interview With Louis Glickman, in New York City, Nov. 27, 1959.

201. Securities Act of 1933, §§ 6-8, 48 Stat. 78-79, as amended, 15 U.S.C. §§ 77f-h (1958).

202. See Securities Act of 1933, § 10, 48 Stat. 81 (1933), as amended, 15 U.S.C. § 77j (1958).

203. Securities Act of 1933, § 7, 48 Stat. 78, 15 U.S.C. § 77g (1958); 48 Stat. 83 (1933), 15 U.S.C. § 77aa (1958) (Schedule A).

204. For the registration statement forms in current use, see 1 CCH FED. SEC. L. REP. ¶¶ 6601-7372. Special forms are available for fifteen classes of securities. *Ibid*. In some instances, the use of a special form, where it applies, is mandatory. Compare 17 C.F.R. § 239.17 (1949), with 17 C.F.R. § 239.13 (1949).

205. 17 C.F.R. § 239.13 (Supp. 1959); form S-3 and instructions are reproduced in 1 CCH FED. SEC. L. REP. ¶¶ 7151, 7157 to 7160-3.

17 C.F.R. § 239.17 (Supp. 1959); form S-10 and instructions are reproduced in 1 CCH FED. SEC. L. REP. ¶¶ 7201-13.

206. LOSS, SECURITIES REGULATION 206 (1951).

207. Form S-1, together with general instructions for its use, are reprinted in 1 CCH FED. SEC. L. REP. ¶¶ 7121-28.

208. The following is a copy of the Cross Reference Sheet included in a registration statement that a proposed real estate syndicate (general partnership) filed on form S-1. The

understresses, matters of great relevance.²⁰⁰ An examination of prospectuses that have passed SEC scrutiny, however, suggests that the Commission is

Cross Reference Sheet shows the page numbers in the prospectus for each item required by 17 C.F.R. § 230.404(c) (1949).

N. A. BUILDING ASSOCIATES
Cross Reference Sheet Pursuant to Rule 404(c)

| Form S-1 Item Number | Prospectus Page |
|---|--------------------|
| 1. Distribution Spread | Cover |
| 2. Plan of Distribution | 4 |
| 3. Use of Proceeds to Registrant | 3 |
| 4. Sales Otherwise Than for Cash | * |
| 5. Capital Structure | * |
| 6. Summary of Earnings | 14 |
| 7. Organization of Registrant | 3, 9 |
| 8. Parents of Registrant | * |
| 9. Description of Business | 3-4, 6-9 |
| 10. Description of Property | 5-6 |
| 11. Organization Within 5 Years | 3-4 |
| 12. Pending Legal Proceedings | * |
| 13. Capital Stock Being Registered | * |
| 14. Long-Term Debt Being Registered | * |
| 15. Other Securities Being Registered | 9 |
| 16. Directors and Executive Officers | * |
| 17. Remuneration of Directors and Officers | * |
| 18. Options to Purchase Securities | * |
| 19. Principal Holders of Securities | * |
| 20. Interest of Management and Others in Certain Transactions | 3-4 |

*Omitted as negative or inapplicable

To further illustrate the difficulties that a real estate syndicator, inexperienced in the ways of the SEC, might face when trying to complete a registration on form S-1, examine the partial instruction furnished by the Commission for Item 10, Description of Property:

State briefly the location and general character of the principal plants, mines and other materially important physical properties of the registrant and its subsidiaries. . . . What is required is information essential to an investor's appraisal of the securities being registered. Such information should be furnished as will reasonably inform investors as to the suitability, adequacy, productive capacity and extent of utilization of the facilities used in the enterprise. Detailed descriptions of the physical characteristics of individual properties or legal descriptions by metes and bounds are not required and should not be given.

1 CCH FED. SEC. L. REP. ¶ 7123.

Real estate syndicators have complained to the SEC about the unsuitability of form S-1. Remarks of Paul Windels, Jr., SEC Regional Administrator, to Realty Investment Syndicators' Ass'n, New York City, Feb. 8, 1958.

209. Contrast the disclosure required by form S-1 with that required by the New York Legislature in N.Y.A.I. No. 2851, 1959 Sess. (Feb. 3, 1959), a syndicate control measure enacted in 1959 and vetoed by the Governor. See notes 233, 236 *infra*. Compare also SEC form S-10 for the registration of oil or gas interests, in 1 CCH FED. SEC. L. REP. ¶¶ 7203-13.

developing a format of disclosure that is meaningful for syndication. Significantly, the finished product bears only fleeting resemblance to Form S-1.²¹⁰ Perhaps the adaptation of a registration form shaped especially for the real estate syndicate would have the two-fold benefit of making clearer the Commission's demands and reassuring the wary promoter that the SEC is making adjustment to syndication's peculiar needs.

Blue Sky Laws

In addition to the federal securities act, a syndicate promotion may be subject to control by each of the states touched by its operations.²¹¹ Under most Blue Sky Laws, as under the Securities Act, "security" has acquired sufficiently broad content to include participations in syndicate ventures.²¹² If the syndicate offering complies with Securities Act disclosure, state regulation may duplicate and, in many instances, extend investor protection. But if federal regulation is ineffectual or unavailing, the prospective syndicate investor must rely primarily upon controls at the state level.

Although to categorize the Blue Sky laws invites oversimplification, three distinctive patterns of regulation emerge: (1) antifraud; (2) security registration; and (3) broker-dealer registration.²¹³

Blue Sky laws designed to prevent or punish fraudulent securities practices were the earliest statutory form of investor protection.²¹⁴ Today, however,

210. See, e.g., The Teagen Co., Prospectus, Aug. 24, 1959; National Munsey Co., Prospectus, Nov. 20, 1959; Dyckman Hotel Associates, Prospectus, Jan. 27, 1959.

211. Excepting Delaware and Nevada, every state regulates the public offering of securities. 1 BLUE SKY L. REP. ¶ 501.

Although the Delaware Code of 1953 omitted his previously expressed authority, the Chancellor's far-reaching general equity powers may enable him to enjoin fraudulent securities dealings. 1 *id.* ¶ 11101.

212. State courts and law officers in applying the Blue Sky Laws have adopted the rule of broad construction to "give effect to remedial legislation." See *McElfresh v. State*, 9 So. 2d 277 (Fla. 1942); *State v. Whiteaker*, 118 Ore. 656, 247 Pac. 1077 (1926) (partnership interest a security); *People v. Hoshor*, 92 Cal. App. 2d 250, 206 P.2d 882 (Dist. Ct. App. 1949) (limited partnership a security); Fla. Att'y Gen. Opinion, 2 BLUE SKY L. REP. ¶ 70388 (1958) (solicitation of limited partners to participate in profit-sharing agreement within definition of securities in Florida Securities Law); *Foreman v. Holsman*, 2 BLUE SKY L. REP. ¶ 70330 (Ill. 1956) (beneficial interest in real estate trust formed to construct and operate apartment building held a security, and not an interest in real estate); *Brown v. Cole*, 155 Tex. 624, 291 S.W.2d 704 (1956) (parties held not to have enjoyed joint control; hence, not exempt joint venture); La. Att'y Gen. Opinion, 1 BLUE SKY L. REP. ¶ 1631.041 (1947).

But see MICH. STAT. ANN. § 19.745(j) (1959) (exempting "joint adventures" defined as voluntary association of not more than 25 individuals); *Grabendike v. Adix*, 335 Mich. 128, 55 N.W.2d 761 (1952) (sale of fractional interests in oil well drilling project held "joint adventure").

213. For a state-by-state rundown, including statutory citations, see LOSS & COWERT 39-42.

214. At least forty jurisdictions now have laws creating civil or criminal remedies for

they serve chiefly as a supplement to state registration requirements.²¹⁶ As an exception to the prevailing pattern, New York²¹⁶ and New Jersey²¹⁷ have stressed the antifraud provisions, as the primary safeguard to the securities investor. Because of the present importance of syndication in the Metropolitan New York area, this aberration has been of some consequence to the syndicate participant. The New York Blue Sky Law, or "Martin Act," empowers the attorney general to investigate, subpoena witnesses and documents in support of investigation, institute injunction proceedings, or apply for receivers in connection with any fraudulent practice arising out of the "issuance, exchange, purchase, sale, promotion, negotiation, advertisement or distribution" of securities within or from the state.²¹⁸ The Martin Act does not define "fraudulent practice," but employs instead such conclusionary terms as "deception, misrepresentation . . . false promise." Brushing aside the argument that the act is "quasi-criminal" and must be construed narrowly, the New York courts have given far-reaching scope to the "fraudulent practice" language, and have justified their position upon the need to protect the inexperienced and credulous investor.²¹⁹ The attorney general's broad civil weapons are given additional leverage by his power to prosecute criminally fraudulent practices both under the Martin Act and under assorted Penal Law²²⁰ violations. The criminal controls, however, have been used far less extensively than the civil.²²¹

an assortment of dishonest practices connected with securities activity. See Loss & COWETT 39-41, 250-52.

These statutes do not generally displace already existing common-law liabilities for deception or fraud. See, *e.g.*, OHIO REV. CODE ANN. § 1707.40 (Page 1953); FLA. STAT. ANN. § 517.22 (1943); WIS. STAT. ANN. § 189.18(7) (1957).

215. Antifraud measures ordinarily operate independently of the registration system. They apply equally to exempt and nonexempt securities or transactions, in much the same way as § 12 of the Securities Act of 1933. See Loss & COWETT 25.

216. N.Y. GEN. BUS. LAW §§ 352-59; N.Y. PEN. LAW §§ 421, 660-62, 664, 926, 951-57. N.Y. GEN. BUS. LAW §§ 352-59, or "Martin Act," is treated as New York's Blue Sky Law. 2 BLUE SKY L. REP. ¶¶ 31101-18.

217. N.J. STAT. ANN. §§ 49:1-1 to -29 (1955); see Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 290-91 (1959).

218. N.Y. GEN. BUS. LAW §§ 352-53.

219. *People v. Federated Radio Corp.*, 244 N.Y. 33, 154 N.E. 655 (1926). See also *People v. Tellier*, 7 Misc. 2d 43, 155 N.Y.S.2d 245 (Sup. Ct. 1956); *People v. Royal Sec. Corp.*, 5 Misc. 2d 907, 165 N.Y.S.2d 945 (Sup. Ct. 1955); *People v. Abbott*, 4 Misc. 2d 565, 147 N.Y.S.2d 256 (Sup. Ct. 1955); *People v. Wachtell*, 181 Misc. 1010, 47 N.Y.S.2d 945 (Sup. Ct. 1943).

220. N.Y. PEN. LAW § 421 ("untrue . . . or misleading advertisement") most concerns real estate syndication.

Several Penal Law sections apply only to corporations. See, *e.g.*, N.Y. PEN. LAW §§ 660, 661, 664. Others may not apply to partnership ventures, for they concern only dealings with "stocks, bonds or evidences of debt." See, *e.g.*, N.Y. PEN. LAW §§ 926, 951-54.

221. Interview With Carl Madonik, Assistant Attorney General of New York, in New York City, Nov. 1958.

The dearth of reported cases involving criminal proceedings for securities fraud tends to confirm that the criminal weapon is infrequently used.

The Martin Act has been enforced fairly vigorously against questionable real estate ventures. Upon learning of the Nassau Management attack, the New York attorney general swiftly exercised his statutory powers.²²² Further subscriptions were enjoined and receivers were appointed to manage the Nassau properties.²²³ The combined salvage efforts of the receivers, investor-committees, and the attorney general have reduced losses to less than one million dollars.²²⁴ But the attorney general often does not have information upon which to act until someone complains, and therefore usually after a questionable promotion has produced actual securities sales.²²⁵ This underscores the essential deficiency of the Martin Act and other antifraud statutes, for they do not become operative, in many instances, until after the investor has parted with his money. Recognizing this shortcoming,²²⁶ the New York attorney general initiated hearings to consider more comprehensive regulation of the real estate syndicate.²²⁷ Interested parties advanced a plethora of regulatory schemes, including an elaborate mechanism for self-policing by the syndicate

222. N.Y. Times, Jan. 25, 1958, p. 40, col. 4.

223. *Id.*, Jan. 23, 1958, p. 1, col. 4 (Supreme Court directs four officers of Nassau Management Company to appear for questioning); *id.*, Jan. 28, 1958, p. 50, col. 1 (receivers appointed); *id.*, Feb. 21, 1958, p. 15, col. 2 (Nassau Management Company enjoined permanently from dealings in real estate shares or other securities in New York State); *id.*, June 6, 1958, p. 1, col. 1 (Nassau Management Company and two officers indicted for grand larceny).

224. *Id.*, Dec. 17, 1959, p. 20, col. 5.

In addition to his role in the Nassau affair, the Attorney General has obtained injunctions against a Brooklyn firm for selling 8% debentures while insolvent, see *id.*, April 4, 1958, p. 29, col. 1, and against a Jamaica concern for defrauding investors in the sale of so-called guaranteed mortgages, see *id.*, April 30, 1958, p. 35, col. 3. In other instances he has acted informally to eliminate borderline practices. For example, in July 1957 he threatened formal Martin Act action against the promoters of five questionable syndications, unless they offered to pay back all moneys (more than \$4 million) received from their investors. Better Business Bureau of New York City, Inc., News Release, Sept. 3, 1957. Although each promoter acceded to the "request," and made the offer, only a few investors accepted. Interview With Carl Madonik, Assistant Attorney General of New York, in New York City, Nov. 1958.

225. Interview With Carl Madonik, Assistant Attorney General of New York, in New York City, March 7, 1960.

226. Because federal disclosure has not been required, New York's attorney general and others have voiced repeatedly their concern for this gap in the protection available for syndicate investors. See, e.g., N.Y. Times, March 16, 1958, § 8, p. 1, col. 4; Better Business Bureau of New York City, Inc., News Release, Sept. 3, 1957 (statement of Hugh Jackson, Pres.).

227. New York Attorney General Lefkowitz held a one-day conference on September 13, 1957. See N.Y. Times, Sept. 14, 1957, p. 19, col. 1. He then appointed retired Surrogate George Frankenthaler to conduct further hearings, *id.*, Sept. 20, 1957, p. 18, col. 2, which were held November 6, 18, 1957. More than twenty witnesses, including syndicators, attorneys, college professors, accountants, and brokers appeared voluntarily. See *id.*, Nov. 7, 1957, p. 61, col. 4; *id.*, Nov. 19, 1957, p. 57, col. 4; see N.Y. *Hearings on Real Estate Syndication Before Hon. George Frankenthaler*, Nov. 6, 18, 1957.

promoters,²²⁸ the use of impartial panels of real estate experts to appraise all syndicated properties,²²⁹ the creation of a centralized information bureau similar to Dun & Bradstreet exclusively devoted to syndicate enterprise,²³⁰ and the imposition upon every syndicate venture of a legally required contingency

228. *Id.*, Nov. 18, 1957, at 2a.

Recognizing an increased community demand for their regulation, and concerned over the bad publicity attending recent disclosures, thirty of the better known New York City syndicators banded together and formed Realty Investment Syndicators Association, Inc. (RISA) in October 1957. Membership in RISA was voluntary, and available not only to the promoters, but also to those in related pursuits—attorneys, accountants, real estate brokers, mortgage bankers.

RISA's announced *raison d'être* was a Code of Ethics and Fair Business Practices, to which all members would subscribe. Under RISA by-laws (§ 5), violation of the Code could bring expulsion and public censure.

The Code requires a limited disclosure for all nonprivate offerings over \$250,000. The promoter must prepare a brochure for review by a RISA panel of at least three lawyers, three accountants, and three "having knowledge and experience in the value and operation of real estate." The panel might conduct hearings, ask for relevant documents, suggest changes, and was to accept or reject the printed brochure based on Code standards. RISA promoters agreed to circulate only accepted brochures.

The Code's disclosure standards (§ 2) are less rigorous than those the attorney general later sought to enact into New York State law. See notes 233-36 *infra* and accompanying text. The Code calls for a full description of the property, mortgages and other liens; identification of the syndicate managers, their interest, compensation, and profit; and a statement of estimated income and expenses. The Code does not provide for a statement of *past* income and expenses; assurances of certified annual reports; and clearly defined distinctions between distributions of capital and income.

Although RISA is still in being, N.Y. Times, Dec. 17, 1959, p. 66, col. 1, the brochure procedure awaits its first use, Interview With J. M. Tenney, New York City, Nov. 27, 1959. No RISA member seriously thinks this event will ever occur. Perhaps it is just as well. The pressure for better investor protection remains where it belongs on the SEC and Blue Sky officials.

229. *N.Y. Hearings on Real Estate Syndication Before Hon. George Frankenthaler*, Nov. 6, 1957, pp. 47-55.

The suggestion came from Sanders A. Kahn, Supervisor of Real Estate Education, City College of New York. Mr. Kahn suggested that the attorney general would set up a master panel of approved appraisers. For each offering, panel members would decide whether the promoter had placed a reasonable value on the syndicated property.

Surrogate Frankenthaler felt that this procedure placed the attorney general in the role of giving or denying approval to proposed ventures, duties similar to the responsibility of most Blue Sky officials. See text at note 240 *infra*. Whatever he may have thought about the benefits to the investor of an unbiased real estate appraisal, Frankenthaler did not want the attorney general in the securities qualification business. Frankenthaler, Report to [N.Y.] Attorney General Louis Lefkowitz, Feb. 17, 1958, copy on file in Yale Law Library.

In some Blue Sky states, the administrator may ask for an appraisal of the issuer's assets. See note 257 *infra*.

230. N.Y. Attorney General, Conference on Real Estate Syndication, Sept. 13, 1957, p. 61.

If requested, the Better Business Bureau of New York City, Inc., will write up and furnish to inquirers any detrimental reports in its files on specified syndicate promoters. The bureau also acts as an informal SEC, by taking complaints directly to the promoter.

reserve.²³¹ Dismissing most of these suggestions as "impractical,"²³² the attorney general instead drafted a legislative proposal based upon the time-tried safeguard of full disclosure, similar to section 5 of the Securities Act, but with its disclosure requirements tailored for the real estate syndicate.²³³ In 1958,

If the complaint seems well-founded, the bureau tries "moral suasion." If this appeal fails, the bureau may then refer the complaint to the attorney general.

Interview With Robert P. Schron, Director of Public Information, Better Business Bureau of New York City, Inc., in New York City, Oct. 24, 1958.

231. *N.Y. Hearings on Real Estate Syndication Before Hon. George Frankenthaler*, Nov. 6, 1957, pp. 58-70.

In urging that syndicates set up "contingency reserves," Meyer Horowitz, a New York attorney, pointed to a venture that needed unexpectedly \$200,000 to repair fire damage. The mortgagee agreed to supply all but \$50,000. The \$50,000 could not be raised and the syndicate folded. Horowitz suggested that the starting reserve be 10%-15% of the cash equity, with annual 2% (of gross income) increments.

The mandatory "reserve" concept has its counterpart in the regulations for FHA-insured cooperatives, 24 C.F.R. §§ 241.30(c), (d) (1959) (fund for replacements and general operating reserve shall be established and maintained), and the regulations for FHA-insured rental projects, 24 C.F.R. § 232.19(f) (3) (1959) (fund for replacement shall be accumulated and maintained).

Mindful that the investor will resist unexpected requests for additional funds after the venture is launched, some promoters have raised, as part of the subscription price, moneys to complete needed improvements. See, e.g., Brocol Realty Co., Brochure, April 1959, p. 6; 501 Fifth Realty Co., Brochure, Nov. 12, 1959, p. 7.

232. Interview With Carl Madonik, Assistant Attorney General of New York, in New York City, Nov. 1958.

233. The disclosure features of the 1958 measure (N.Y.A.I. No. 4236, 1958 Sess. (March 5, 1958)) were changed slightly in the 1959 bill (N.Y.A.I. No. 2851, 1959 Sess. (Feb. 3, 1959)), note 235 *infra*. Under both proposals, syndicators who made public offers or sales in or from New York State were to file an offering statement with the attorney general at least ten days prior to a public offering. Under the 1959 measure, the offering statement would have made the following disclosure:

(b) The detailed terms of the transaction;

A description of the property, the nature of the interest, and how title thereto is to be held;

the gross and net income for a reasonable period immediately preceding the offering where applicable and available;

the current gross and net income where applicable and available;

the basis, rate and method of computing depreciation;

a description of major current leases;

the essential terms of all mortgages;

the names, addresses and business background of the principals involved, the nature of their fiduciary relationship and their financial relationship, past, present and future, to the property offered to the syndicate and to those who are to participate in its management;

the interests and profits of the promoters, officers, syndicate organizers, directors, trustees or general partners, direct and indirect, in the promotion and management of the venture;

all restrictions, if any, on transfer of participants' interests;

1959,²³⁴ and again in 1960,²³⁵ the legislature acted on the attorney general's

a statement as to what stock or other security involved in the transaction, if any, is non-voting;

a statement as to what disposition will be made of the funds received and of the transaction if not consummated, which statement shall represent that all moneys received from the sale of such securities until actually employed in connection with the consummation of the transaction, shall be kept in escrow as a trust fund, and that in the event insufficient funds are raised through the offering or otherwise to effectuate the purchase or purchases or other consummation of the contemplated transaction, or that the intended acquisition shall not be completed for any other reason or reasons, then such moneys shall be returned to the investor;

which of the securities offered are unsecured;

clearly distinguish between leasehold and fee ownership, between fact and opinion; a commitment to submit annual reports to all participants, including an annual balance sheet and profit and loss statement certified by an independent certified public accountant;

clearly distinguish between those portions of promised distributions which are income and those which are a return of principal or capital;

and such additional information as the attorney general may prescribe in rules and regulations . . . as will afford potential investors, purchasers and participants an adequate basis upon which to found their judgment. . . .

234. N.Y. Times, March 26, 1958, p. 20, col. 4; 1959 N.Y. LEGIS. SERV. 156 (N.Y.A.I. No. 2851, 1959 Sess., introduced in Assembly by Assemblyman Russo and referred to Ways and Means Committee); *id.* at 181 (companion bill N.Y.S.I. No. 2416, 1959 Sess., introduced in Senate). N.Y.A.I. No. 2851, The Russo Bill, closely resembled the ill-fated measure of 1958. It had these differences:

- (1) The ten day prior-to-offering period for filing offering statements with the Department of Law was dropped.
- (2) The attorney general received discretion to exempt:
 - (a) An offering to forty persons or fewer;
 - (b) Securities fully registered with the SEC or exempt from SEC registration other than intrastate offerings to New York residents.
- (3) All violations were deemed fraudulent practices, hence misdemeanors, (compare N.Y. GEN. BUS. LAW § 352-c). In the 1958 bill, failure to treat subscription moneys as a trust fund prior to their use in consummating the transaction was treated as a felony.
- (4) Appropriation to the Department of Law reduced to \$50,000.

In addition to the Russo Bill, two other proposals were introduced; these died in Committee. See 1959 N.Y. LEGIS. SERV. 96 (N.Y.A.I. No. 1345, 1959 Sess.) (syndicator to file semi-annual financial report with attorney general); *id.* at 156, 222 (N.Y.S.I. No. 3521, 1959 Sess.) (syndicator to file prescribed offering statement with Department of Law).

235. See Letter From Carl Madonik, Assistant Attorney General, New York State, to Curtis J. Berger, April 7, 1960, on file in Yale Law Library. The 1960 measure was introduced by Assemblyman Russo, N.Y.A.I. No. 2466, 1960 Sess., and Senator Anderson, N.Y. S.I. No. 1856, 1960 Sess. Its disclosure features are virtually unchanged from those approved by the Legislature in 1959. See note 233 *supra*.

If Governor Rockefeller signs the current bill, syndicate control in New York State will move forward significantly. But the measure has at least one major deficiency. Although syndicators of nonexempt offerings will be required to file a prospectus with the Department of Law, the bill does not provide for systematic review, in the SEC fashion, to determine whether the prospectus meets the disclosure standards.

recommendations. In the first two instances the Governor vetoed the proposals;²³⁶ he has not yet acted on the 1960 measure.

Blue Sky security registration provisions are frequently more rigorous than the Securities Act requirements. This departure is significant to the prospective investor, for it reflects a fundamental difference in regulatory policy. Whereas the federal objective is full disclosure, regardless of the potential investment risks, the prevailing Blue Sky goal is guarding the would-be investor from the temptation of a questionable offering.²³⁷ Accordingly, security registration in most states is completed only if the issue "qualifies" for sale within the jurisdiction.²³⁸ In the first instance, the issuer, underwriter, or broker-dealer files a disclosurelike registration statement with the Blue Sky administrator, who reviews the filed documents to assure himself that the disclosures are materially complete and devoid of statements likely to mislead.²³⁹ As an additional responsibility, however, the administrator is also directed to judge whether the underlying transaction merits public participation. His judgment that the offering "qualifies" is a prerequisite to lawful public solicitation. An adverse judgment places the nonqualifying jurisdiction "out-of-bounds" to the proposed offering, unless the applicant can overturn the finding upon appeal.²⁴⁰

236. N.Y. Times, April 24, 1958, p. 27, col. 4 (1958 veto by Governor Harriman) ; 1959 N.Y. LEGIS. SERV. [unpaginated bill history] (1959 veto by Governor Rockefeller).

In 1958, both the Realty Investment Syndicators Association and the Committee on State Legislation, Bar of the City of New York, beseeched Governor Harriman to veto the syndicate-control measure, although they stated quite different reasons. RISA objected chiefly to the act's criminal provisions. See Letter From RISA to Governor Harriman, April 7, 1958. The 1959 bill dropped the felony penalty, see note 323 *supra*, and RISA dropped its opposition, Interview With Carl Madonik, Assistant Attorney General, New York State, in New York City, March 7, 1960.

The bar association committee criticized the act's broad coverage which seemingly included not only real estate syndicates, but also bank and investment trust securities. "Such a fundamental change in New York's blue-sky law should not be effected without comprehensive consideration of the possible effects of the change upon security issued by others than so-called real-estate syndicates." The Comm. on State Legislation, Ass'n of the Bar of the City of N.Y. Resolution No. 165 (1958). In addition, the committee pointed out the inconsistencies with the Federal Securities Act (the exemptions in the 1959 bill would have removed these), and urged even stronger regulatory controls, including attorney general review of all filed offering statements, if the act confined these controls to real estate syndicates.

237. See Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 292 & nn.31-32 (1959), citing Loss & Cowett 30-42, 67-77, 282-331.

238. Loss & Cowett 30-36.

239. Representative procedures based on securities qualification would include KAN. GEN. STAT. ANN. §§ 17-1258 to -1260 (Supp. 1959); WIS. STAT. ANN. §§ 189.13-16 (1957); CAL. CORP. CODE ANN. §§ 25500-15. See Loss & Cowett 39-42.

240. See, e.g., FLA. STAT. ANN. § 517.24 (1943); N.D. REV. CODE § 10-0415 (1943).

Ordinarily, the unsuccessful Blue Sky applicant will have little luck on review, since the administrator's discretion is upheld absent a showing such as fraud, abuse of power, or unreasonableness. See, e.g., *Doble Steam Motors Corp. v. Daugherty*, 195 Cal. 158, 166, 232 Pac. 140, 143 (1924); *State ex rel. Hardstone Brick Co. v. Department of Commerce*, 174

Diverse standards guide the administrators in their qualitative determination. Most of these are couched in general phrases: "the sale . . . would work a fraud, deception, or imposition upon the purchasers";²⁴¹ "the issuer's plan of business is unsound";²⁴² "the enterprise . . . is against public policy."²⁴³ A number of statutes, or the regulations promulgated under them, are more explicit in reference to promotional ventures. Factors which may result in "nonqualification" include the issuance of promotional shares for less than fair value;²⁴⁴ the failure of the independently appraised promoter's equity to reach a required percentage;²⁴⁵ the use of a limited partnership;²⁴⁶ the issuance by new corporations of debt securities or preferred stock;²⁴⁷ the issuance of promoter shares which carry with them majority control²⁴⁸ or exclusive voting rights.²⁴⁹ Even if the administrator is disposed to qualify the offering, he may exercise various other controls to safeguard the investor. Quite commonly, Blue Sky officials are empowered to regulate the use and content of advertising media,²⁵⁰ set maximum limits on underwriting commissions,²⁵¹ impound

Minn. 200, 219 N.W. 81 (1928). In at least one jurisdiction, however, the administrator's action may be challenged in a trial de novo. UTAH CODE ANN. § 61-1-41 (1953); *Lauren W. Gibbs, Inc. v. Monson*, 102 Utah 234, 129 P.2d 887 (1942).

241. ALA. CODE ANN. tit. 53, § 12(2)(a) (1941); *accord*, ILL. REV. STAT. ch. 121½, § 137.11 H (1957) ("fraud or deceit"); HAWAII REV. LAWS § 199-10 (1955) ("fraudulent"); *Loss & Cowett* 325, 328-29.

242. See, e.g., FLA. STAT. ANN. § 517.09(7) (1943) ("business . . . based upon unsound business principles"); IND. STAT. ANN. § 25-836 (1948) (same); ALA. CODE ANN. tit. 53, § 12(2)(d) (1941) ("plan . . . unfair, inequitable").

243. ALA. CODE ANN. tit. 53, § 12(2)(g) (1941); *accord*, WIS. STAT. ANN. § 189.16(7) (1957) ("any [other] reason . . . appropriate in the public interest"); N.C. GEN. STAT. ANN. § 78-11(2)(g) (1950).

244. See, e.g., 2 BLUE SKY L. REP. ¶ 38720 (Ohio Ruling 20: Sales of similar securities at varying prices "grossly unfair"); ALA. CODE ANN. tit. 53, § 12(2)(f) (1941); KAN. GEN. STAT. ANN. § 17-1260(a)(3) (Supp. 1959) (promotional shares exceed "reasonable value" of property exchanged).

245. See, e.g., 2 BLUE SKY L. REP. ¶ 46602 (Tex.: 10% promoter's cash equity required if developmental venture); 1 *id.* ¶ 16627 (Ill.: if fair value of promoter's equity less than 15%, offering presumed "inequitable").

246. See, e.g., 1 *id.* ¶ 8632 (Cal.: ordinarily, a limited partnership will be considered with disfavor as the basis for a promotional enterprise).

247. See, e.g., 1 *id.* ¶ 13641 (Fla.).

248. See, e.g., 2 *id.* ¶ 34601 (N.M.: promotional stock not to exceed 50% of offering); 1 *id.* ¶ 5612 (Ala.: "equitable participation" between shares sold for cash and promotional shares); 1 *id.* ¶ 8618 (Cal.: promotional securities shall in no event have over 50% participation rights).

249. See, e.g., 2 *id.* ¶ 38719 (Ohio Ruling 19: issuance to public investors of non-voting shares without specified dividend rights "grossly unfair"); 1 *id.* ¶ 15609 (Idaho: no favorable consideration where promotional security has greater rank than security sought to be qualified).

250. *Loss & Cowett* 381.

A number of qualification states bar the use of advertising matter that has not been submitted to and approved by the Blue Sky commissioner. See, e.g., MINN. STAT. ANN. § 80.18

sale proceeds pending the marketing of the security,²⁵² place promotional shares in escrow,²⁵³ prohibit distributions on promotional shares until a stated return has been paid to the public investors,²⁵⁴ require the filing of a fidelity bond,²⁵⁵ obtain service of process designation from nonresident principals,²⁵⁶

(Supp. 1959); WIS. STAT. ANN. §§ 189.01-.30 (1957). Thus, if the issuer does use sales literature, the investor may benefit from disclosure as well as qualification. On the other hand, if the issuer does not use advertising matter, the investor will only be protected by qualification. In these states, as well as in states where the Blue Sky commissioner does not review promotional media, the essential difference between the disclosure aims of the Federal Securities Act and the qualification philosophy of the Blue Sky Laws is emphasized. Even though the security has qualified, the investor may not have the disclosure necessary to making a considered investment choice.

Only a few Blue Sky jurisdictions impose upon the issuer a positive duty to supply each offeree with a copy of an approved prospectus. See, *e.g.*, LOSS & COWETT 305-06.

251. See, *e.g.*, 2 BLUE SKY L. REP. ¶ 52610 (Wis. 15%); 2 *id.* ¶ 34606 (N.M. 20%); 2 *id.* ¶ 37607 (N.D. 15%); 1 *id.* ¶ 5615 (Ala. 15%); 1 *id.* ¶ 8615 (Cal. 10%-20%). See also LOSS & COWETT 329.

252. See, *e.g.*, CAL. CORP. CODE ANN. § 25508; CAL. ADMIN. CODE tit. 10, §§ 393-402; ILL. REV. STAT. ch. 121½, § 137.11(d) (1957). See also LOSS & COWETT 312.

253. See LOSS & COWETT 311-12; *e.g.*, KY. REV. STAT. § 292.200 (1953) (escrow until other investors have been paid for two years, dividends aggregating not less than 6% "actually earned on the investment"); KAN. GEN. STAT. ANN. § 17-1259(d) (Supp. 1959) ("escrow . . . [pending] dividends aggregating not less than six per cent . . . actually earned"); Ga. Laws 1959, No. 86, § 11 (in 1 BLUE SKY L. REP. ¶ 14103-1) (escrow at Comm'r's discretion for period not exceeding two years); CAL. ADMIN. CODE tit. 10, § 407-21.

Shares subject to escrow are variously defined as: "securities issued for services rendered . . . for a monetary consideration 'substantially lower' [than sales price to public]," CAL. ADMIN. CODE tit. 10, § 368; "securities issued in payment of property, . . . promotion," KAN. GEN. STAT. ANN. § 17-1259(d) (Supp. 1959); "securities issued for . . . promotion fees or expenses," KY. REV. STAT. § 292.200 (1953).

Query: What happens when more than one Blue Sky commissioner seeks to escrow the same promotional shares, and in different depositories? Cf. UNIFORM SECURITIES ACT § 305(g). Aside from the infrequency of their use, LOSS & COWETT 312, escrows, as now permitted, would not be helpful where the syndicate promoter does not receive units in the venture, but does receive directly part of the sales proceeds for a contract assignment, or where, as in Motors Building Realty Company, note 190 *supra*, the issuer did not sell out the entire offering in the original promotion and ended up owning over \$400,000 in participation units. See Motors Building Realty Corp., Prospectus, Oct. 21, 1959, p. 5 (secondary offering).

254. See, *e.g.*, CAL. CORP. CODE ANN. § 25508 (promotional shares to waive some dividend rights while held in escrow).

255. See, *e.g.*, ALA. CODE ANN. tit. 53, § 12(3) (1941); MISS. CODE ANN. § 5365 (1957); WYO. STAT. ANN. § 17-109 (1959).

256. See LOSS & COWETT 220-22, 406; *e.g.*, CAL. CORP. CODE ANN. § 25505(b); KAN. GEN. STAT. ANN. § 17-1263 (Supp. 1959); WIS. STAT. ANN. § 189.13 (1957).

Some statutes, including New York's, go a step further and permit substituted service against a nonresident issuer who is doing business within the state even though he has not registered. N.Y. GEN. BUS. LAW § 352-a; UNIFORM SECURITIES ACT § 414(h); LOSS & COWETT 407-09.

order an independent appraisal of all assets,²⁵⁷ and require the submission of periodic financial statements.²⁵⁸

In every Blue Sky state, some groups of securities escape registration through exemptions roughly paralleling those embodied by the Securities Act. Exempt transactions abound as well. Among these, most states have some counterpart to the section 4(1) private offering, but they customarily reduce the confusion of the Securities Act by specifically injecting quantitative content into the exemption.²⁵⁹

Even when registration becomes necessary, not every offering must "qualify." Registration by notification or description, which contemplates the filing of a simple informational return, is widely available for securities issued by a "going concern,"²⁶⁰ or debentures secured by real estate first mortgages.²⁶¹ Registration by coordination, designed especially for issues simultaneously undergoing Securities Act registration, is a feature of several statutes.²⁶² Co-

257. See, e.g., 1 BLUE SKY L. REP. ¶ 5628 (Ala.: independent appraisals to determine value where Commissioner deems it advisable); 1 *id.* ¶ 15633 (Ill.: mandatory appraisal of issuer's assets if issuer engaged in business less than five years); 1 *id.* ¶ 8622 (Cal.: licensee shall furnish an appraisal when requested).

258. See, e.g., CAL. CORP. CODE ANN. § 25515 (financial reports to be submitted as required by commissioner); ILL. REV. STAT. ch. 121½, § 137.11(c) (1957) (financial statements as often as circumstances may warrant).

259. For state counterparts of § 4(1), see, e.g., WIS. STAT. ANN. § 189.07 (1957) (15 security holders); WASH. REV. CODE ANN. § 21.20.320(9) (1959) (not more than 20 offerees within state). See also LOSS & COWETT 368-74; UNIFORM SECURITIES LAW § 402(b)(g) (not more than 10 offerees within state).

260. See, e.g., FLA. STAT. ANN. § 517.08(1) (1943) (issuer in continuous operation not less than three years, with specified minimum earnings record); KAN. GEN. STAT. ANN. § 17-1256(a)(1) (Supp. 1959) (issuer "in continuous operations not less than five years,"); OHIO REV. CODE ANN. § 1707.05(A) (Page 1953) (issuer or guarantor in continuous operations not less than three years); UNIFORM SECURITIES ACT § 302(a)(1). For a discussion of the notification procedures, see LOSS & COWETT 284-89.

261. See, e.g., OHIO REV. CODE ANN. § 1707.05(B) (Page 1953) (first mortgage not exceeding two-thirds "fair market value" of mortgaged property located in United States or Canada); KAN. GEN. STAT. ANN. §§ 17-1256(a)(2)-(3) (Supp. 1959) (first mortgage on agricultural lands not exceeding 60% of then "fair market value" of lands plus 40% of insured value of improvements; first mortgage on improved city, town, or village real estate not exceeding 60% of then fair market value); MINN. STAT. ANN. § 80.09(2) (1946) (first mortgage on agricultural lands not exceeding 70% of then fair market value of lands, including improvements; first mortgage on city or village real estate not exceeding 70% of then fair market value including improvements; if net rental lease, net annual income, after deducting operating expenses and income at least equal to annual interest plus not less than 3% of mortgage principal).

262. See, e.g., VA. CODE ANN. § 13.1-509 (1956); TEX. REV. CIV. STAT. ANN. art. 581-7C (Supp. 1959); KAN. GEN. STAT. ANN. § 17-1257 (Supp. 1959). These provisions are modeled on UNIFORM SECURITIES ACT § 303. Its authors consider registration by coordination the Act's most popular feature. LOSS & COWETT 291.

Some Blue Sky administrators are willing, in the absence of express authority, to adjust informally their registration procedures to accommodate an issuer undergoing SEC registration. *Ibid.*

ordination simplifies the paper work of a federal-state registration by enabling the issuer to submit documents already filed with the SEC. The Blue Sky administrator, however, retains the privilege to test the securities against the state's qualification standards.²⁶³ Registration by coordination is seldom available for small issues filing under Regulation A.²⁶⁴

Even if the proposed offering is nonexempt and ineligible for a simplified registration, qualification and the accompanying controls may not result in a high level of investor protection. In many jurisdictions, Blue Sky laws are enforced by part-time officials,²⁶⁵ for whom security regulation is one of many diverse responsibilities. Blue Sky administrators are typically overworked, ill-paid, understaffed, inexperienced, and prone to political and local pressures.²⁶⁶ Due to such deficiencies of administration, the parties to a security offering may deliberately choose noncompliance or, quite commonly with local transactions, fail to recognize the Blue Sky implications.

To date, Blue Sky administrators have been asked only occasionally to stamp their approval upon syndicate offerings.²⁶⁷ With the prospective increased use of syndication, the contact between issuer and administrator may be reasonably expected to increase. The present application of many qualification statutes might disqualify, perhaps automatically, the bulk of syndicate ventures, and should invoke, almost certainly, the use of various auxiliary controls upon those offerings which qualify.

The syndicate's vulnerability in the face of qualification requirements stems chiefly from two of its recurring traits—the small quantum of investor control, and the large quantum of promoter reward, in the form of immediate profit or a participation interest. Several states regard as "inequitable" exclusive voting control in the promoter.²⁶⁸ Even corporate or partnership pro-

263. Under registration by coordination, the issuer files, as the major part of his registration statement, three copies of the SEC prospectus, and an undertaking to forward all amendments to the federal registration statement. The Blue Sky registration statement becomes effective simultaneously with the SEC registration, if: the statement has been on file with the administrator for at least ten days, a statement of maximum and minimum proposed offering prices and maximum proposed underwriting discounts and commissions has been on file for at least two days (the administrator may shorten this period), and the administrator has not issued a stop order. The administrator may stop the offering if the security does not qualify. *UNIFORM SECURITIES ACT* §§ 303(b)(c).

264. See statutes cited note 262 *supra*. But see *WASH. REV. CODE ANN.* § 21.20.180 (1959).

265. In 1958, the responsible officials in only 23 jurisdictions devoted full time to Blue Sky Law administration. In 15 states, securities regulation was less than a half-day affair. *LOSS & COWETT* 47-52.

266. See *id.* at 55-64.

267. Interview With Edward M. Cowett, New York Attorney, in New York City, Feb. 12, 1960; Letter From Charles F. Carpentier, Secretary of State of Ill., to Curtis J. Berger, Nov. 15, 1958, on file in Yale Law Library ("10 applications to register real estate syndicates and cooperative housing offerings in Illinois during the past five years"); Letter From Edward J. Samp, Director, Wis. Dep't of Securities, to Curtis J. Berger, Oct. 29, 1958, on file in Yale Law Library (only one "for some time").

268. See note 249 *supra*.

visions which grant the public investor a modicum of voting privilege—*e.g.*, the right to approve a sale or mortgage of syndicate property, the assertion of control following dividend defaults—are certain to be carefully scrutinized.

Blue Sky censure based upon the inadequacy of the promoter's equity, or the disproportionate value of promotional shares, seems more reasonably related to investor protection. A promoter whose reward is assured upon the successful marketing of the syndicate units, especially if he has little of his own capital tied up in the venture, may have little incentive to maximize the profits of the public participants. The use of an undeviating percentage standard, however, for testing whether the promoter's profit is "fair" seems overly rigorous if uniformly applied to all ventures, for each syndication is sufficiently distinctive to warrant a flexible, individualized analysis. Factors for an administrator's consideration in weighing the fairness of the promotional interests include the size and forfeiture risk of the promoter's deposit; whether the venture is developmental—*i.e.*, rehabilitation or new construction—thereby demanding of the promoter greater resourcefulness and energy; whether the promotional profits are realized from the offering proceeds rather than postponed or subordinated pending a minimum return to the public investor; the extent to which the benefits of an improved operation or a resale profit are earmarked for the promoter and investor.

The apprehension with which syndicators might view the qualification process is exemplified by the syndication of the General Motors Building leasehold.²⁶⁹ Seeking to raise over five million dollars in the spring of 1958, the promoter embarked upon an interstate solicitation, and accordingly registered his offering pursuant to Securities Act section 5. But when he sought Blue Sky approval, the administrators in California, Illinois, Michigan, and Wisconsin denied the applications.²⁷⁰ The explanations for the Illinois and Wisconsin rejections are instructive. Illinois based its action on the size of the promoters' equity investment (less than fifteen per cent), the assurance of an immediate 450,000-dollar profit to the general partners, and the promoters' use of a wholly-owned management company and operating lessee to furnish additional profits from the venture.²⁷¹ Wisconsin looked to the small size of the promoters' investment, the lack of voting rights in the investors, the promoters' failure to disclose the sublessee's financial status, and the use of a pictorial prospectus.²⁷² Thus both emphasized the seeming unfairness of the pro-

269. See Motors Building Realty Co., Prospectus, June 3, 1958.

270. Letter From Louis A. Siegel, Senior Vice President, Glickman Corp., to Curtis J. Berger, Feb. 24, 1960, on file in the Yale Law Library. The securities were able to be sold in 32 states and the District of Columbia. *Ibid.*

271. Securities Div., Secretary of State, Ill., Special Bull. No. 114, Notice of Withdrawal of Application, Nov. 14, 1958.

272. Letter From Edward J. Samp, Director, Wis. Dep't of Securities, to Curtis J. Berger, Nov. 7, 1958, on file in Yale Law Library.

Administrators have been debating the "integrity" of prospectuses including pictures and art work, and at least two states, Florida and Texas, have banned them. The SEC has permitted the use of pictorial prospectuses, probably on the theory that photographs will

motors' potential rewards in contrast with his minimal risk. Neither expressed concern, perhaps because they were unauthorized to do so, with certain substantive features of the scheme—the shortness of the primary lease term,²⁷³ dependence upon a single sublessee with cancelable leases covering nearly eighty per cent of the building,²⁷⁴ the possibility of substantial capital expenditures in the near future²⁷⁵—which seem quite detrimental to the syndicate participant. Their approach suggests, therefore, that security qualification, even when conscientiously administered, is no substitute for investor analysis. At best, qualification is a relatively unrefined screening process designed to reduce the number of investment choices permitted by a pure disclosure statute.

Most states provide for registration of persons engaged in security dealings with the public.²⁷⁶ Broker-dealers, their agents, and, in some states, issuers²⁷⁷ are generally expected to register with the Blue Sky commissioner.²⁷⁸

In many states, broker-dealer registration resembles security qualification, in that the administrator has power to grant, deny, revoke, or suspend licenses.²⁷⁹ Often his judgment is directed by the statute to such criteria as financial responsibility, good repute, or the fairness of the proposed business plan.²⁸⁰ When the registrant furnishes details of the securities he intends to handle, the administrator's regard for the securities becomes a compelling

render the prospectus more attractive and enhance the likelihood that investors will read the entire brochure. See Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 298 (1959).

273. The ground lease acquired by the syndicate expires on July 31, 1979, but it contains an option to renew for an additional term ending December 31, 2007. See Motors Building Realty Co., Prospectus, June 3, 1958, p. 12. By 1979, however, the General Motors Building will be 52 years old, well past middle age for a major midtown Manhattan structure. *Id.* at 5-6. Should the syndicate still own the leasehold in 1979 and want to replace the building, the shortness of the renewal term followed by reversion to the fee owner in 2007 would prove a formidable barrier to such action.

274. The tenant, General Motors Corporation, has a cancellation privilege for 29% of its space as of April 1963. The remaining 71% leased by General Motors may be vacated in 1968. *Id.* at 5. Should the cancellation privilege be exercised to its maximum permissible in 1963, the annual rent paid by General Motors will drop from \$1,700,000 to \$1,150,000.

275. Substantial costs may be incurred to remodel for new tenants in 1963 or 1968 should General Motors vacate its present space. *Id.* at 7.

276. Forty-six states license or register securities brokers or dealers. See Loss & Cowett 26. For a compilation of respective state statutes, see *id.* at 39-42.

277. See, e.g., N.Y. GEN. BUS. LAW § 359-e; TEX. REV. CIV. STAT. ANN. art. 581-4C (Supp. 1959).

More than twenty statutes require the issuer to register if it is planning to market any securities to the public without the intervention of licensed broker-dealers. Loss & Cowett 336. For nondealer treatment, see MICH. STAT. ANN. § 19.761 (1959).

278. For exemptions, which are generally narrower than those available where registration of securities is required, see Loss & Cowett 333.

279. *Id.* at 271-77.

280. *Ibid.* For representative statutes, see CAL. CORP. CODE ANN. § 25706; CONN. GEN. STAT. § 36-280 (1958) (registration denied if conviction within 5 years of criminal offense involving securities); ILL. REV. STAT. ch. 121½, § 137.8 (1957).

factor, thus, in a few states, security analysis takes place as part of the broker-dealer registration.²⁸¹ Bonding,²⁸² reporting,²⁸³ and bookkeeping²⁸⁴ requirements often condition the granting of the licenses.

New York has one of the simplest and, from the investor's view, least satisfactory procedures.²⁸⁵ The registrant files a name and address notice with the Department of State, and a statement of his criminal record, educational background, and prior business history with the Department of Law; in addition, whenever the registrant wishes to deal in a specific nonexempt security, he must file a further notice listing the name of the security, its issuer, address, and place of organization. Presumably, the notice filed with the Department of Law is intended to alert the attorney general to a condition, such as a prior felony conviction for securities fraud, which would warrant the exercise of his injunction-seeking powers.²⁸⁶ Otherwise, the attorney general has no independent power to appraise and impose limits on the intending dealer. When the notices are filed, registration is completed.

Broker-dealer registration adds little to the Blue Sky protection given the real estate syndicate investor. Except for removing the least wholesome persons from the syndicate business (provided they bother to register), and giving the Blue-Sky administrator, in the qualification states, a second, and unnecessary, crack at the syndicate venture, broker-dealer registration is useful only if and when it encourages security analysis by the administrator in states with no other qualification procedure. The registration of broker-dealers in New York may have, instead, an unintended perverse effect, if the investor should rely upon the fact of registration, despite its rudimentary scope, to enhance his regard for the syndicator and the proposed venture.

CONCLUSIONS AND RECOMMENDATIONS

That syndication has made available hitherto untapped investment funds for the financing of real estate transactions is neither an unmixed blessing nor an undeserving phenomenon. Syndication's potential benefits are impressive: as an alternative, and sometimes attractive, outlet for investors seeking higher yield risks; as a technique for broadening the ownership base of realty; as an additional source of developmental real estate capital, particularly in a con-

281. For example, securities are not registered in Pennsylvania, but broker-dealers are. And at any time the administrator may require a dealer to list the securities that he is selling. If the administrator finds that any of such offerings "either (1) have not been made honestly, or (2) have not been made in good faith, (3) have been made with intent to deceive or defraud, or (4) have been made without the dealer's having a reasonable amount of information concerning the issuer thereof . . .," he may prohibit their sale. PA. STAT. ANN. tit. 70, § 44 (Supp. 1958). See also N.H. REV. STAT. ANN. § 421:29 (1955); ME. REV. STAT. ANN. ch. 59, § 229 (1954).

282. See LOSS & COWETT 142-46.

283. *Id.* at 268-69.

284. *Id.* at 268.

285. N.Y. GEN. BUS. LAW § 359(e) (2) (f).

286. N.Y. GEN. BUS. LAW § 353.

tinuing "tight-money" era; as a means of facilitating the marketing of real estate properties, which, by increasing liquidity, may have the bootstrap effect of increasing the attractiveness of realty investment. Partially offsetting these benefits, however, are the potentially destructive consequences which may flow from the deleterious features of certain syndications. To protect public investors from their own lack of knowledge or from unscrupulous syndicate promoters, some independent control is needed. The basis for this control is already available, and is contained in the federal Securities Act of 1933 and the state Blue Sky Laws. Because a syndicate participation interest is clearly a "security" within the broad sweep of these laws, governmental power to regulate their public offering and sale, as well as the venture's postorganizational activity, has not been successfully challenged. Despite the presence of the power, however, neither federal nor state authority is having a sizeable regulatory impact upon current syndicate activity, since perhaps ninety per cent of syndicate ventures evade the network of disclosure contemplated by the Securities Act, or the more discriminating qualification procedures of most Blue Sky Laws. Although one hundred per cent registration of syndication enterprise may not be a practicable ambition, its present boundaries need and can be greatly extended.

The 3(a)(11) intrastate exemption, as a means of Securities Act avoidance, has been repeatedly misused. Although the evidence of this abuse is frequently public record, the SEC has been lackadaisical in curbing such practice, despite oft-stated threats. By a well-publicized exercise of its strong arm, directed at a few patent violations, the SEC might achieve a far-reaching effect on promoters who lean too heavily on section 3(a)(11). Even if the SEC were to take section 3(a)(11) seriously, however, enforcement might result in an increase in the number of syndicate ventures whose investors were not entitled to SEC disclosures, since promoters might become more selective in their choice of property and offerees. Thus, the intrastate exemption is a big gap in federal syndicate control.

The extreme approach at reform would be repeal of section 3(a)(11). Constitutional barriers to the regulation of wholly intrastate offerings might be surmounted if power were based on regulation of the mails, forbidding use thereof to offers which do not meet prescribed standards. (Presumably, if the mails were not used, an intrastate venture would, even after repeal, escape federal surveillance.) But the political and practical effects of eliminating completely the intrastate exemption may be considerable, particularly during an Administration reluctant to expand federal activity if the states can do the job. And substantially increasing the burden upon the SEC's already strained facilities is not administratively feasible if satisfactory control is available at the state level. Instead of outright repeal, Congress should establish standards and then enlarge the SEC's rulemaking power to permit the agency to condition the availability of section 3(a)(11). In this way, the Commission can apply a turncock on the flow of regulated intrastate transactions, depending upon the adequacy of alternative control under local Blue Sky Laws. Thus,

the SEC might decide to render unavailable the intrastate exemption in New York and New Jersey, where there is presently no state-controlled disclosure. But in those states where the investor received satisfactory disclosure, additional Federal control would be superfluous, and the issuer in a localized transaction might by SEC ruling be permitted to dispense with a Securities Act registration.

The private offering exemption has also created a substantial statutory gap through which real estate syndicates have sought to avoid federal registration. Unlike section 3(a)(11) that seems to have acquired a unique relevance for the real estate syndicate, section 4(1) is utilized by a variety of other major securities transactions. Thus, any proposal directed to the repeal or extensive revision of the private offering exemption seems inappropriate in an Article on real estate syndication.

The *Ralston Purina* case makes it clear that syndicate promoters who rely on section 4(1) will have the laboring oar if either the SEC or a disenchanted investor challenges the failure to register. And this is as it should be. But the promoter should not be left to guess whether, in an after-the-fact determination, his offering will be deemed private. Instead, the Securities Act might provide the mechanism for the promoter to obtain a prior opinion as to the availability of the section 4(1) exemption. In seeking an opinion, the issuer would state his plans for marketing the security, including the identity, number, and business background of the proposed offerees, their relationship to the promoter, and some details of the securities; given these facts, the SEC would decide whether the exemption fitted the intended transaction. The Commission's opinion that an exemption was available would be subject, of course, to the promoter carrying out his offering as contemplated.

Expanded federal control over the real estate syndicate is only a half-step forward, unless it is coupled with improvements in registration procedure—to facilitate promoter compliance and to make the final prospectus a more meaningful document in the hands of the syndicate investor. The most urgent need is for a registration form tailored to the real estate syndicate.

If it were to prepare a special registration form, the SEC might usefully examine for its model the New York legislative proposals. The syndicate promoter should be required to stress, and the investor should have before him in an uncomplicated presentation, factors relevant to real property ownership and syndicate involvement. For an existing structure, these would include: physical condition of the real estate, including a description of elevators, air conditioners, heating and electrical systems, and other major building components; competitive factors, including location, existing tenants and rental arrangements, vacancy rates, new construction; financing; past, current, as well as projected operating statements; the identity of the operator of the property, and the terms, including security for the performance, of the operating agreement; the extent of investor control over the venture; what arrangements, if any, are present for the marketability of a syndication unit; a breakdown of the syndicate distribution into income and return of capital; an anal-

ysis of the assumption under which the projected tax treatment depends; and the sources and amounts of promoter reward.

Disclosure to the investor should not end after the venture takes being. Investment is a continuing choice-process depending on up-to-date information. The Securities Exchange Act of 1934 recognizes this by requiring larger concerns to furnish annual reports to their investors. Yet once he has made his investment, the average member of a real estate syndicate receives only the barest information about the continuing operating performance of the property in which he has an interest. This sparseness of detail reflects the usual relation of the syndicate to the property—that of a landlord under a long-term net lease. As the net landlord, the syndicate may not be entitled to the operating particulars. Hence, the syndicate only furnishes to its members a report of net rental received, with appropriate deductions for depreciation and perhaps debt service.

But, as has been demonstrated, the operating tenant is often the syndicate promoter or his affiliate. In these instances, although the promoter, as a member of the syndicate, may not receive operating reports, the promoter, as the operating tenant, has first-hand knowledge of the property's affairs. The promoter knows, for example, by what margin the property has earned its net rental, whether or not the margin is improving, and even whether a margin exists (for the syndicator may have "fed the kitty" from his own pocket or by commingling the revenues from other properties also under his control). If this knowledge is available to the promoter as the operating tenant, then it surely belongs to the syndicate member or to anyone considering an investment in the syndicate.

Although the adoption of these reforms can raise the level of disclosure and improve its tone, it hardly follows that syndication will become a risk-free mode of investment. But for the amateur investor, who is attracted to syndication, federal and state regulated disclosure may help him better to understand and to evaluate his risks.

APPENDIX I

THE KRATTER CORPORATION, PROSPECTUS

| <i>Properties Held</i> | <i>Type of Ownership</i> | <i>Rate of Depreciation or Leasehold Amortization for Federal Income Tax Purposes</i> | <i>Cumulative Depreciation or Leasehold Amort. for Federal Income Tax Purposes to Dec. 31, 1958</i> | <i>Cash Distributions Paid by Limited Partnerships to Dec. 31, 1958</i> | <i>Estimated Total Annual Net Income (Loss) After Depreciation & Leasehold Amort. for Fed. Income Tax Purposes</i> | <i>Estimated Percentage of Taxability of Distributions for 1959</i> |
|--|--------------------------|---|---|---|--|---|
| Thirty-Four Associates: The Kratter Building New York, N.Y. | fee | 38 years-150% declining balance method | \$1,182,052 | \$ 549,969 | \$(119,512) | 0 |
| Pratney Associates: Pratt & Whitney Plant West Hartford, Conn. | fee | 16.4 years-150% declining balance method | 2,047,851 | 1,349,998 | (117,653) | 0 |
| King Edward Associates: King Edward Hotel New York, N.Y. | fee | 16 $\frac{2}{3}$ years, Building; 5 years, Fixtures-150% declining balance method | 251,633 | 140,613 | 11,459 | 45.26% |

| | | | | | | | |
|---|-----------|--|---------|---------|---------|--|--------|
| Transamerican Associates: | | | | | | | |
| Parking Garage Baltimore, Md. | fee | 33½ years-150% declining balance method | 42,017 | | | | |
| Office Building Baltimore, Md. | fee | 15-year life-150% declining balance method | 109,752 | | | | |
| Lunt-Fontanne Theatre New York, N.Y. | fee | 25 years, Building; 10 years, Fixtures-150% declining balance method | 28,662 | 263,938 | 144,060 | | 61.30% |
| Long Beach, Cal. | leasehold | 65 years, leasehold; 24 years, 2½ months improvements-straight line | 5,962 | | | | |
| Phoenix, Arizona | leasehold | 38 years, 10 months life-straight line | 12,672 | | | | |
| 3450 Associates: Tishman Buildings Los Angeles, Cal. | leasehold | 11-year life-straight line | 586,849 | 628,137 | 18,144 | | 8.27% |
| Fawcett Association: Fawcett Building New York, N.Y. | leasehold | 2,950 days straight line | 32,542 | 21,749 | (4,844) | | 0 |
| Mart Associates: Western Merchandise Mart San Francisco, Cal. | leasehold | 326-month life-150% declining balance method | 742,096 | 480,000 | 87,486 | | 34.11% |